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Corporate Governance Going Astray – Executive Remuneration Built to Fail

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Abstract

Modern remuneration systems for executive directors to a large extent contain elements of performance based pay. The idea behind this is that by rewarding executives for performance their interests become aligned with those of the company's shareholders, thus bridging the principal-agent gap. Executive remuneration through performance based pay has become an explicit corporate governance tool that is supposed to improve the governance of companies. Others have argued that the governance and design of performance based pay system is often poor, as result of which the principal-agent problem actually increases. This paper argues that even if we can improve the governance and design of executive performance based pay, it cannot be made to work because people behave differently than performance based pay assumes. Research revealing our bounded rationality, bounded awareness and bounded ethicality shows that we simply cannot handle executive performance based pay.

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I. Bonuses of contention

Most of the modern academic thinking on corporate governance starts from the understanding that in public companies with dispersed ownership an agency relation exists between the managers as agents whose decisions affect the shareholders as principals. Corporate governance and underlying company law mechanisms are very much about addressing the issues triggered by this relationship, seeking to ensure that managers act in the interests of shareholders. Classic company law tools such as appointment and dismissal rights, disclosure, monitoring through supervisory or non-executive directors, can all be seen as mechanisms that aim to address the agency problems. A relatively new corporate governance mechanism, introduced in the 1990s, is to align the interests of managers with the interests of shareholders through the remuneration of executive directors. This was done by making remuneration of executives dependent upon certain performance targets having been met and by paying executives in stock options and shares of the company. Scholars in the US claimed that the problem of executive remuneration was not that CEOs received too much pay, but that their pay was not related to the performance of companies (Jensen, Murphy 1990). The US government stimulated performance based pay in 1993 by providing that non-performance-related compensation in excess of \$ 1 million was no longer deductible as an ordinary business expense for corporate income tax purposes (Omnibus Budget Reconciliation Act of 1993). The result was, first, that many companies increased non-performance-based cash compensation to \$1 million and then began to add on performance based pay that satisfied the new tax act (Jensen, Murphy 2004). Performance based pay primarily took the form of stock options, based on the belief that stock options did not present a cost to the company. Europe was quick to catch up with performance based pay. Large cash bonuses, stock option and share awards have become common features of remuneration packages of executive directors of EU listed companies.

Performance pay, popularly captured under the now ominous term “bonuses”, in the meantime has become highly contentious in the wake of the financial crisis. Many believe extreme variable pay schemes have led executives, managers and traders of financial institutions to excessive risk taking with short term private benefits for themselves and the risks shifted to the institutions. Public outrage has been triggered even more by the continuation of excessive bonus payments by some financial institutions while they and other institutions with which they trade have received billions and billions of aid from governments, paid for by tax payers’ money (Sandel 2009). Although performance based pay did receive criticism before the financial crisis (Bebchuk, Fried 2004, Jensen, Murphy 2004), the public and political outrage after the crisis go way beyond such criticism and cause a major rift between financial institutions, and perhaps the business community at large, and the rest of society. Both the public outrage and the lack of responsiveness from the industry preclude a sensible debate about the effectiveness of performance based pay. My sense is that we can only return to normal if both sides of the debate would focus on what performance based pay is actually doing. This article seeks to contribute to such a debate. The key argument is that performance based pay for executives not only suffers from the original criticism of bad governance and poor design, but that it cannot be made to work because people behave differently than performance based pay assumes. I think we have shot ourselves in the foot with a governance mechanism that was supposed to mitigate the agency problem but has aggravated it instead. My argument is not of a legal nature but is concerned primarily with the reality of being human that underlies our rules and practices. It precedes the legal judgments we make of what we should regulate and how.

I make two provisos. The first is about scope. This article is about performance based pay for executive directors of listed companies, as a governance response to the perceived agency problem of well informed managers who are in control and may not always act in the interest of less or uninformed dispersed shareholders. I am not making the claim that performance based pay never works in any setting, although I do believe the evidence presented here may also be relevant for the effectiveness of performance based pay in other settings. The second proviso is that I am not certain of the conclusions that I draw from the arguments in this article. We are often fooled by our own belief of knowing something to be true (Burton 2008, Schulz 2010). The arguments and underlying evidence presented here appear to make sense to me and side with me more comfortably than arguments that seek to support performance based pay for executives. I also acknowledge that I am not objective, or

at least not more objective than average. I come from a background, I have had experiences, I have studied materials and I have discussed, all of which create and reinforce a basis for being more comfortable with the arguments presented here. I trust that others with different backgrounds, experiences and acquired understandings will bring their arguments to the table. Only our dialogue will bring matters forward.

II. Initial criticism: the governance and design of executive remuneration

Criticism of performance based pay systems to reward executives is not new. In 2004 *Bebchuk* and *Fried* published their book “Pay without Performance, the Unfulfilled Promise of Executive Compensation” (Bebchuk, Fried 2004). The core element of their argument is that performance based pay for executives assumes that a company’s board of directors negotiates pay arrangements at arm’s length from executives, which does not happen in reality. “Directors have had various economic incentives to support, or at least go along with, arrangements favorable to the company’s top executives. Various social and psychological factors – collegiality, team spirit, a natural desire to avoid conflict within the board team, and sometimes friendship and loyalty – have also pulled board members in that direction. Although many directors own shares in their firms, their financial incentives to avoid arrangements favorable to executives have been too weak to induce them to take the personally costly, or at the very least unpleasant, route of haggling with their CEOs. Finally, limitations on time and resources have made it difficult for even well-intentioned directors to do their pay-setting job properly.” *Bebchuk*, *Fried* suggest a number of improvements both to pay schemes (for example, reducing windfall profits) and to the governance and transparency of performance based pay schemes, including requiring shareholder approval of equity based plans.

After having promoted performance based pay as a means to mitigate the principal – agent problem, *Jensen* and *Murphy* have reviewed actual pay practices in 2004, concluding that the design is often poor (for example on performance targets) and that boards typically simply ratify executive’s remuneration initiatives (Jensen, Murphy 2004). Directors should be much less dependent of the CEO, boards should be chaired by a person who is not the CEO and remuneration committees should take full control over the process and should seldom, if ever use compensation consultants for executive compensation purposes who are also used by the firm for actuarial or lower level employee remuneration assignments.

Regulation of executive remuneration until now also primarily focuses on the governance of remuneration: the role of independent non-executive directors, shareholder vote on remuneration policy or remuneration reports and on share-based schemes of remuneration, independence of remuneration consultants, disclosure of individual director pay etc.¹ Some of these elements have been laid down in mandatory regulation, other elements have been included in corporate governance codes (for an overview *Ferrarini*, *Moloney*, *Ungureanu* 2009). More recently some attention is given to the design of remuneration schemes, in particular seeking to mitigate the short term incentive provided by variable pay and to limit severance pay, certainly in case of non-performance. Regulation, as the initial criticism, assumes that performance based pay can be made to work if only it would be designed and governed better. If we succeed in providing for a better design and governance, the thinking is that performance based pay would be desirable or acceptable at the least.

III. Can we handle executive performance based pay?

Research from a wider field of cognitive sciences seriously questions whether performance based pay for executives can ever be made to work. The nature of the challenges has everything to do with who and how we are as human beings. The evidence provided comes from new research into how we make decisions and choices, our biases, our blind spots, our self-serving nature and our perceptions of fairness, in short, as *Bazerman* and *Moore* call it: our bounded rationality, our bounded awareness and our bounded ethicality (Bazerman, Moore 2009). Somehow little of the findings of this research has found its way to the debate on performance based pay for executives. The basic

¹ See for example the Recommendations of the EU Commission relating to executive remuneration of 14 December 2004, Fostering an Appropriate Regime for the Remuneration of Directors of Listed Companies and of 29 April 2009, Completing the Recommendation of 14 December 2004 and the Recommendation of 15 February 2005 [on the role of non-executive directors, jw], see http://ec.europa.eu/internal_market/company/directors-remun/index_en.htm.

assumption still is that if executives have monetary incentives to produce enterprise value which eventually flows to shareholders they will indeed do so. The implicit assumption for promoting performance based pay is that executives are insufficiently motivated to produce enterprise value for the benefit of shareholders without explicit monetary incentives. These assumptions ignore what effects such incentives in reality have. They also ignore the effects of the incentive system we have designed on our preferences, our thinking and our behavior. The two key elements of this system are the setting of performance targets and benchmarking with peers. In the following paragraphs I will discuss what we know about incentives, target setting and benchmarking and why this, at least for me, destroys the validity of our assumptions underlying performance based pay for executives. It appears that we simply cannot handle performance based pay.

IV. Incentives and Behavior

Economic theory has long held that monetary incentives improve performance. Since the governance crisis at the start of this millennium it has been recognized that in particular stock options as the mechanism that was introduced to reward executives may provide perverse incentives. *Coffee* explained how the surge in stock option schemes in the 1990s has led to a proportionate surge in restatements of annual accounts by listed companies in the US (*Coffee* 2003). Shares acquired under stock option schemes could be sold immediately, which lead executives to drive up the stock price through aggressive earnings forecasts, which they then satisfied by premature earnings recognition thus sustaining higher market valuations. This game went on mostly unnoticed as it was played during a sustained bull market in the 1990s, causing investors, analysts, auditors and other gatekeepers to suspend their usual skepticism. The 2007-2008 financial crisis has spurred more criticism on variable pay schemes in the form of cash bonuses, in particular for the asymmetry between risk and reward ingrained in cash bonus schemes: the immediate reward of a cash bonus is for the executive while the long term risk caused by the actions that have led to meeting short term turnover and profitability targets lies solely with the financial institution. Requiring to defer a substantial part of the cash bonus for three or four years, as the EU Commission Recommendation of 29 April 2009 suggests, is intended to reduce this asymmetry.²

But the problem with monetary incentives lies much deeper. A growing body of psychological research raises serious questions about the effects of monetary incentives. An important phenomenon that is now widely evidenced is *crowding out*. Monetary incentives appear to have the effect that the intrinsic motivation of people to perform a certain task well is moved aside by the extrinsic monetary incentive. This often has the effect that people actually perform less than without the monetary incentive. An often cited example of the crowding out effect are the fines that a day care center in Israel imposed on parents who arrived late to pick up their children, which resulted into more parents coming late. The fine was quickly perceived as a price to be paid for additional services, which substituted the feeling of guilt or obligation parents may have towards their children and their caretakers (*Gneezy, Rustichini* 2000). The crowding out effect has also been widely researched in relation to incentives for blood donors. Some results indicate that giving financial incentives actually reduces the number of donors, while more recent research indicates that different incentives such as free cholesterol testing may have positive effects.³ Some economists have questioned the relevance of the psychological evidence of crowding out effects in pro-social environments (day care centers, blood banks) to economic relations where people expect to be paid for their efforts (*Prendergast* 1999, *Fehr, Falk* 2002). Nonetheless there is evidence that also in economic relations the crowding out effect occurs (*Frey, Jegen* 2000, *Gächter* 2002). Various theories explain for the crowding out effect. One explanation offered by *Fehr* and *Gächter* is that without explicit incentives agents perceive their contracts to contain an implicit obligation to provide efforts, based on social norms of cooperation and reciprocity (*Fehr, Gächter* 2000). Once an explicit incentive is introduced the perception may shift to the understanding that effort is only required because of and according to the incentive, and the social norms as a basis for providing effort are forgotten. *Ariely* offers a variety of examples, among which the example of lawyers who generally refuse to offer services for retirees at a very low rate of \$ 30 an

² See sec 3.3 of the Recommendation of 29 April 2004, see fn 1 above.

³ *Goette, Stutzer* (2008)

hour, but overwhelmingly agree to offer those services for free (Ariely 2008). The low fee signals that the activity is governed by market norms with sharp-edged exchanges and no place for pro-social behavior. Without the fee being offered the perception is that the activity is governed by social norms, based on our need for community and mutual help. Based on cognitive evaluation theory *James* provides a different explanation, holding that an extrinsic incentive may provide intrinsic satisfaction if the incentive indicates competence, but it will not do so if it is perceived as controlling (James 2004). When the size of the incentive is large it will primarily be perceived as controlling, as it rationally compels the agent to attribute his efforts to the incentive rather than to his own preferences.

The crowding out effect is not all. A different strand of research indicates that monetary incentives have a negative impact on creative, non-mechanical tasks. In 1945 *Duncker* conducted an experiment, giving participants a candle, a box of thumbtacks and a book of matches and asking them to fix the candle to the wall so that it would not drip on the table below. Many participants try to fix the candle to the wall with the thumbtacks, or to glue it to the wall by melting it, which all does not work. Only a few find the solution to empty the box of the thumbtacks and fix the box to the wall with the tacks as a platform for the candle to stand on. *Duncker* has called this phenomenon functional fixedness: we fail to see that the box can be used for anything else than to hold the thumbtacks.⁴ *Glucksberg* reported in 1962 that participants who are told they will receive a reward for solving the candle problem faster actually are slower in solving the problem than participants who are only told they are being timed in order to find out how fast people can solve the problem (Glucksberg 1962). The reward narrows the cognitive focus, blocking creativity. This is in line with conclusions drawn by *Condry* and *Chambers* in 1978 that rewards often distract attention from the process of task activity to the product of getting a reward (Condry, Chambers 1978). In other words, the carrot in front of our eyes blinds us, in particular when we need to perform complex tasks, requiring assessment of complex information. This is a cognitive analogy to limitations in our visual perception called inattention blindness. We have a tendency to only see what we are looking for and to miss what we are not looking for, even when we are staring directly at it. This is established over and over again with short films of two basketball teams in black and white outfits. When asked to count the number of times the white team passes a ball people typically miss the bear moonwalking between the players.⁵ *Pink* concludes that incentives only work for straight-forward, mechanical tasks, and not for anything that requires more than a minimum of cognitive skills (Pink 2010).

Perverse incentives, crowding out and narrowing of cognitive focus, the evidence from modern research is that the effect of monetary incentives on the performance of complex cognitive jobs is likely to be negative. The job of an executive is a complex job, requiring not only strong analytical skills but also an awareness of and an openness to yet unknown or uncertain factors and information and the ability to weigh opportunities and risks in light of these uncertainties. The alignment theory as a justification for performance based pay in itself is a strong signal that the performance contingent incentive is intended to be controlling, seeking to ensure that the executives as agents perform in the interests of shareholders as principals, which they, apparently, would not do otherwise. The insistence by shareholders that executives should only be paid if there is clear, measurable performance gives the same signal. The variable part of total pay of the executive has increased substantially over the last decade and a half. This has enforced the crowding out effect and at the same time has narrowed the cognitive focus of executives to ensuring that targets will be met and the performance based pay is actually paid.

V. Target setting, gaming and cheating

A crucial element of performance based pay for executives is setting targets in advance and measuring if and to what extent these targets have been met. The pay-out is then related to the actual achievement in relation to the pre-set targets. Based partly on experience and partly on perception, shareholders and code regulators have insisted that the targets to be set should be objective and measurable and should be disclosed to the extent not competition sensitive. This should help

⁴ See http://en.wikipedia.org/wiki/Functional_fixedness and http://en.wikipedia.org/wiki/The_Candle_Problem.

⁵ See <http://www.break.com/index/awareness-test.html>. See also the colour changing card trick on <http://www.youtube.com/watch?v=voAntzB7EwE>.

shareholders to assess whether there indeed has been performance that should be rewarded. It should also limit the scope for rigging the system of performance based pay by executives.

I leave aside here that the targets often used in performance based pay systems offer only a one-sided, often short term perspective on performance that is to be rewarded, typically produced by financial performance indicators that happen to be available. Regulation attempts to deal with this by insisting that longer term targets and non-financial targets should be used to measure performance that is to be rewarded. But target setting has a number of negative side effects that are completely ignored in the discussion on executive remuneration. As *Ordonez, Schweitzer, Galinsky* and *Bazerman* write on the basis of a study of literature on goals setting and performance, target setting can narrow focus, motivate risk-taking, lure people into unethical behaviour, inhibit learning, increase competition, and decrease intrinsic motivation (Ordonez, Schweitzer, Galinsky, Bazerman 2009). *Jensen* describes the same phenomenon for the other example of goal setting we are so completely accustomed to: budgeting. *Jensen* calls budgeting a game that pays people to lie twice, both at the setting of the budget and when measuring whether the budget has been met or not. "Tell a manager that he or she will get a bonus when targets are realised and two things are sure to happen. First, managers will attempt to set targets that are easily reachable, and once the targets are set, they will do their best to see that the targets are met even if it damages the company to do so." (Jensen 2003) Performance indicators corrupt immediately when they become targets that need to be met in order to receive a certain reward. *Jacob* and *Levitt* conducted research into the *cheating by teachers* of Chicago public schools, which increased when the Chicago school district introduced a new system for holding schools accountable for student learning, including the right to close down schools that consistently underperformed (Jacob, Levitt 2004). *Schwartz* describes the ultimate effect of financial incentives: more and more incentives destroy our moral will, our will to do right (Schwartz 2009). The cheating that goes on in target-setting and measurement in business is ubiquitous and at the same time accepted as a matter of fact. Paradoxically, most people engaged in this process do not see themselves as being dishonest. People typically value honesty; it activates our internal reward system. Cheating may provide a material gain, but it reduces our positive self-concept. *Mazar, Omir* and *Ariely* have developed a theory explaining how people who generally perceive themselves to be honest, nonetheless can engage in cheating (Mazar, Omir, Ariely 2008). The ability to combine cheating with a view of ourselves as honest increases when we can categorize our actions and find rationalizations that allow us to reinterpret our actions in a self-serving manner. This ability reduces when we pay more attention to honesty-standards. One powerful self-serving rationalization that is often used is that others do it too. In corporate life this cheating has become very much the norm when it comes to target setting for budgeting purposes, in particular when performance based pay is related to such targets, with very little or no attention at all to standards of honesty and integrity. The result is that target setting defeats its purpose of ensuring that only real and objectively measurable performance is rewarded.

VI. (Bad) luck

Another, related problem with performance based pay is that it tends to reward windfall profits, increases in performance which are just a result of general market developments rather than real performance of executives. The solution is to try to single out the individual performance of a company as compared to general market trends. But even if we are able to do so, the isolated performance of the company is not a straight-forward indication of the performance of executives. In his well known book *The Black Swan Nassim Taleb* describes how we typically overestimate our own influence on success and ignore factors which are often more relevant: timing, circumstances and pure luck (Taleb 2007). We tend to create narratives to find meaning in events and we tend to do so in a self-serving way, ignoring that reality is mostly more complex, fuzzy and messy. Similarly, we underestimate our influence on failure and are all too quick to blame circumstances outside our control. This correlates to an opportunistic shift of perception of what is supposed to be rewarded, value or merit. When times are good, the creation of value by the company is perceived as the performance that should be rewarded, regardless of how much value was actually created by the specific performance of the executives. When times are not so good and little or no value is created, the "extraordinary efforts" of

the executives need to be rewarded. This is confirmed by research indicating that executive pay is most sensitive to industry or market benchmarks when such benchmarks are up but much less so when they are down. Executives are paid for good luck, but not punished for bad luck (Garvey, Milbourn 2003).

The tendency to overestimate our performance fits into a pattern in which we generally view ourselves in a more positive light than is objectively accurate. The basis for this tendency is our motive to affirm self-worth. People react to negative information about themselves by making more self-serving attributions that affirm their worth. When we find our self-worth affirmed, we feel less need to make self-serving judgments (Bazerman, Moore 2009). An old saying from the northern part of the Netherlands where I come from is that when you fall when ice-skating the cause "is either the ice or the skates". Our need to continuously affirm our self-worth in a self-serving way creates *cognitive dissonance* when performance targets have not been met. We will look for other reasons outside our own performance to explain the failure to reach targets. To preserve our self-worth we then explain that we worked very hard in a difficult market, which justifies that we receive our bonus. Or we start to cheat to ensure that targets will be met, to the possible detriment of the company, or to show that targets have indeed been met while in reality they have not.

VII. Benchmarking for fairness and status

A final essential feature of modern executive remuneration schemes is the benchmarking of the performance of the company to the performance of other companies in a peer group. Similar to the insistence on objective and measurable targets, benchmarking was introduced to provide for a more objective standard of the company's performance and, possibly, to exclude windfall profits. And as with performance targets, the composition of peer groups has been widely manipulated in order to ensure that executive remuneration would go up regardless of performance. But the heart of the problem is much more pervasive. Benchmarking is an expression of the human reality that we perceive the fairness of our income in relative terms, relative to what others make for similar or different jobs. Not only executives compare their incomes, we all do, secretaries, truck drivers, doctors, lawyers and professors. If we see that others doing a similar job receive more than we do, we feel treated unfairly if we do not receive more as well (Layard 2005).

One particular element of the benchmarking of executive remuneration warrants special attention. Remuneration policies typically provide that the company will reward its executives above the median, or sometimes in the top quartile of the peer group. The argument for this has generally been that a company with an ambition to be successful cannot afford to pay its executives only in the lower 50% of the companies it compares itself with. The result is well known: the remuneration of executives of all companies will go up structurally. If a company is not yet paying its executives in the upper half, it will have to increase remuneration to get above the median. As a result another company will drop from the upper half and will have to increase its executive remuneration to get back above the median and so on and so forth. Benchmarking with executives of other companies and paying above the median have an autonomous effect of pushing executive remuneration up, unrelated to any increase in performance of any of the companies. A German executive once said at a conference: "I know I am being overpaid, but the benchmark shows I am not being overpaid enough!" This effect has been ubiquitous across business over the last decade and a half: executive remuneration has gone up steeply compared to the performance of companies which did not go up proportionally and sometimes did not go up at all. Recent research conducted by the Central Planning Bureau of the Netherlands shows that the average income of executives of listed companies in the Netherlands increased 9% annually between 1999 and 2005 (with the years of excess still to come), while economic value added and profits did not on average increase during the same period. 4.8% of the 9% can be explained as a result of inflation, increase in scale and aging, the additional rise cannot be explained (CPB 2010). Many blame the disclosure of individual directors pay, which has been made mandatory in many EU member states in the last few years (Ferrarini, Moloney, Ungureanu 2009), as the root cause for this effect on executive pay. I do not think it is the main cause. Benchmarking would have taken place also without disclosure of individual director pay. It is the core business of remuneration consultants advising companies and their non-executive directors on pay levels and structures. Paying above the

median as a remuneration policy, regardless of performance is the real culprit. Interestingly, the Dutch Banking Code, adopted by the Dutch association of banks, the NVB, in the wake of the financial crisis, provides it is best practice to reward bank executives just below the median.⁶ If everybody would follow this practice as meticulously as rewarding above the median was practiced, executive remuneration of bank executives should approach zero over time.

The fairness of executive remuneration as executives perceive it themselves is closely related to social status. In our world of financial capitalism, remuneration has become the key measure for the status of executives. It is the same with fund managers, investment bankers, management consultants, doctors and lawyers. High remuneration signals high social status among peers. The problem with social status is that it is a zero sum game: if you have more status than I have, then I should get more by receiving even higher pay, after which your status will have been reduced and you need to get paid more in order to get more status etc (Layard 2005). We see it at all levels in society, in particular when comparing goods material. It explains conspicuous consumption, a term first used by *Veblen* in 1899 to indicate the lavish spending on goods and services mainly for the purpose of displaying income or wealth (Veblen 1899). The same social status sensitivity explains why repeatedly people prefer an absolute lower income for themselves provided their relative position as compared to neighbors or peers improves (Solnick, Hemenway 1998). The Russian peasant, whose neighbor has a cow, when asked by God how He can help, answered: "Kill the cow." (Layard 2005) We all continuously need to *keep up with the joneses* and executives are no different. The status factor probably is even more important than the actual income derived from pay schemes as such. Most executives when asked admit that they do not need the high income they receive and would be willing to cut back but only when others accept a cut-back too. This fits with other research indicating that the only situation where we may accept a pay cut is when others are doing the same (Bewley 1999). The annual executive pay rankings that newspapers produce and that often cause certain levels of aversion among the public, paradoxically at the same time serve as a status signal to the executives concerned, pushing them to demand even higher pay. Executives in a way are trapped in a rat race of all against all that nobody can ever win.

VIII. Regulation will not help

The research described here indicates that the difficulties with executive remuneration are much more fundamental than previously discussed. Financial incentives often work counterproductive, in particular when the incentives are large and the job to be done is cognitively complex. Performance based pay on the basis of pre-set targets induces manipulation and cheating, while our self-serving nature allows us to maintain that we are honest, deserve the pay and ignore the cost of lack of integrity. With remuneration as the key indicator of status for executives, they are all trapped in an upward spiraling race that no one can ever win. I very much doubt that any new design or better governance of executive pay schemes can solve these fundamental problems of performance based pay for executives. Additional design elements are likely to enhance the control-nature of the incentives, targets and wider conditions of performance based pay. They will have precisely the unintended effect of crowding out executives' intrinsic motivation to perform well and will provide ever more incentives to cheat and manipulate and to not feel bad about it. It is an illusion to think that non-executive directors, let alone shareholders will ever be as sophisticated as executives in understanding what performance targets really mean and what levers can be pulled to ensure that targets will be met. A solution would be for executives to simply all agree to cut back and abstain from counterproductive, ever increasing remuneration. But executives have a collective action problem; there are simply too many players who would need to agree.

A typical response in such a situation would be to regulate executive remuneration, prohibit performance based pay or at least restrict it substantially. The prospects of such regulation however are dim if not only executives, non-executives and shareholders of listed companies, but human resource thinking in commercial and non-commercial organizations generally, including more and more in the public sector, hail performance based pay as the mechanism to enhance performance of managers and employees. Regulation will never be realistic if we do not fundamentally reconsider the

⁶ See par. 6.3 of the Dutch Banking Code, see <http://www.nvb.nl/index.php?p=16248>.

pros and cons of performance based pay. Also, the problem of ineffective and counterproductive executive pay in essence is a private problem, the consequences of which are suffered by companies and shareholders in the first place. Specific regulation may be justified in view of public interests, such as risk management and fair treatment of customers for financial institutions, or as a response to generally felt unfairness of bankers cashing in bonuses while financial institutions worldwide have been saved with trillions of taxpayers money. Other than that, I see little scope for the state in regulating executive remuneration. Regulation of executive pay will not change the fundamental beliefs that people have created about the benefits of performance based pay. In all likelihood regulation will have precisely the opposite effect. The more we regulate, the more our responsibility focuses on compliance rather than on the effect of our behavior. The more rules we make the more we only care about following the rules and think that within the rules we are free to do whatever suits us best, regardless of the consequences for others (Winter 2010).

Companies and their shareholders will have to come to their senses: performance based pay for executives is not a solution for the alignment problem, not because of the design or governance but because of who we are.

IX. A paradigm change

Coming to our senses is easier said than done. The business community and the financial industry within it have created a strong belief that performance based pay is the right way to remunerate executives. With executives being on the bonus drip for almost two decades and remuneration consultants depending on creating benchmarks and designing complex performance based pay systems there are powerful vested interests to maintain the current remuneration paradigm. So what should we do? I offer three things: deconstruct the myths surrounding performance based pay, building a new narrative and some lessons for the key actors: shareholders, non-executives and executives. None of this is rule or incentive based. And none of this is of a quick-fix nature.

Deconstructing Myth

The business community (companies and their shareholders) has created a cascade of myths surrounding performance based pay that its members have massively started to believe in. The myths include:

- performance based pay for executives actually enhances overall performance of companies
- the more performance based pay the better the performance of the company
- executives personally create success for their companies
- when executives lead companies to higher performance they are entitled to receive part of the gains
- executives only perform well when they have “skin in the game”
- substantial performance based pay is essential to retain first class managers in an international market for executive talent
- financial rewards are the key indicators of personal success.

The combination of these myths leads to *worldviews* and *frames of reference* that have come to dominate the business community and how it behaves. *Erhard, Jensen, Zaffron* and *Granger* describe worldviews and frames of reference as “the network of unexamined ideas, beliefs, biases, prejudices, social and cultural embeddedness and taken for granted assumptions through which an individual interprets and interacts with the world, other people and himself or herself [worldview, jw] or with a given specific something in his or her world [frame of reference, jw]”. (Erhard, Jensen, Zaffron, Granger 2010) They are the lenses through which we view the world and specific things within it. They constrain and shape what we see and perceive, both the world as such and specific things in it, and therefore they also constrain and shape the way we are and relate to the world and specific things in it. The problem with worldviews and frames of reference is that it is very hard to see them. They are like water to the fish, invisible to us who have them. Our worldviews and frames of reference are stored as representations in our brain through vast amounts of memory that are recalled to deal with the present and immanent. These neural representations of what we are dealing with shape our perception of what is really there, which shapes a prediction of the way it works which in turn generates a pattern of

action consistent with that prediction. The pattern of action that follows may not be consistent at all with what is actually there. Here is an example of how it works.

David de Cremer, a Rotterdam based professor of Behavioural Business Ethics, recently interviewed fifteen executives of Dutch banks, with some revealing results (De Cremer 2010). They all believed that others in the banking world find bonuses more important for performing well than they themselves do. Our self-serving bias in full operation. The conviction that others need bonuses to perform well is the basis for the myth that the industry must offer bonuses in order to retain their executives. De Cremer continues with asking the executives to make a choice between two types of bankers to manage their personal wealth. Type A banker only works for his personal financial incentive, type B banker has a genuine interest in banking matters and wants to provide service to customers. All executives said they would bring their money to banker B. The self-created myth about what sort of remuneration is needed to retain talent leads banking executives to hire the people they would not entrust with their own money. Who is fooling whom?

As long as the unexamined biases, prejudices, assumptions etc. that build the worldview and frames of reference of executives, non-executives and shareholders remain unchallenged, the current folly of substantial executive performance based pay is destined to continue. Our standard legal (i.e. rules prohibiting or prescribing behaviour) and economic (i.e. incentives determining the behavior of rational subjects) approaches will not challenge the myths surrounding performance based pay, they are based on these myths. They need to be fundamentally innovated with the input of modern cognitive sciences. Only then we can expect to dilute and break down the myths of executive performance based pay. This takes lawyers and economists to be open to the knowledge gathered outside their own disciplines and cognitive scientists to take an interest in the specifics of executive performance based pay as a fundamental governance problem. Insight into what really makes us tick is the crucial starting point for any transformation.

Building a New Narrative

Deconstructing the myths surrounding executive performance based pay will also require that an alternative remuneration narrative is built. The new narrative should include a few key elements:

- *Make remuneration less significant*: rather than using remuneration as a primary instrument to steer executive behavior we should reduce the importance of remuneration. Money is a threshold motivator: it motivates only up to a baseline, beyond that it does not do much and likely more harm than good. Companies should remunerate their executives in such a way that remuneration no longer is an issue. People can then focus on their work and performance, which are no longer just perceived as factors that determine income.
- *Benchmark internally instead of externally*: the crucial factor that can move remuneration off the table is fairness. Fairness here is relative fairness, compared to what others receive for similar or different jobs. As long as people perceive that their remuneration is unfair in light of what others receive remuneration will remain an issue. Our current model is set to focus excessively on external fairness, in relation to peers in the industry. At the same time internal fairness is often ignored completely, with executive remuneration becoming ever higher multiples of average employee pay.⁷ Refocusing benchmarks on internal fairness will help to stop the upward spiraling that is the result of automatic benchmarking with external peers, pushing remuneration up without any connection to underlying performance. Internal benchmarking in reality is much more relevant than external. The position of executives in different companies is difficult to compare in detail, certainly for companies in different countries and across Channels and Atlantics. Benchmarking remuneration details with those of other companies is over-simplifying the different realities of companies. The so-called market for international talent in practice is rather limited, most executives will not be able or willing or asked to move to other countries to work there as executives. By focusing on external benchmarking with peer groups we exaggerate the external fairness component to the detriment of internal fairness. A refocusing on internal fairness is needed, as the most

⁷ See for example http://www.afcio.org/corporatewatch/paywatch/pay/index.cfm#_ftn1, indicating that while CEO pay in the US was 42 times average employee pay in 1980, it rose to 525 times in 2000, and then fell back to 263 in 2009.

important benchmark to satisfy fairness concerns. The Dutch Corporate Governance Code now provides as best practice that the executive remuneration should take into account the remuneration ratios within the company.⁸ This would avoid another negative effect of external benchmarking, which is to suggest that executives are in fact mercenaries: they will come for the money and they will go for the money. Most companies need executives who are committed more to the company's future than to their own remuneration. The external benchmark at best should be a sanity check on the remuneration of executives, not the primary factor determining it, applied with wisdom and sometimes simply ignored when enough is enough.

- *Reduce variable pay substantially and use a wide set of collective targets:* executive variable pay today often doubles or triples fixed pay. This triggers the cognitive focus on everything that can ensure the desired outcome regardless of the risks or costs involved. Variable pay should be reduced substantially as part of overall compensation. When the Dutch Corporate Governance Committee, of which I was a member, in 2003 suggested that as a matter of best practice variable pay should not exceed fixed pay, we were derided by all as it was going against the established myths. After the financial crisis the same provision has become part of the Dutch Banking Code, a specific corporate governance code that was developed to apply to banks on top of the Corporate Governance Code in order to restore public trust in banks. The same now applies to insurance companies.⁹ Under these provisions the executives can still double their income through variable pay, a big carrot right in sight. It would probably be better to reduce performance based pay even further, so that it is only an extra to express true appreciation for results achieved, not based on previously set targets. As long as performance based pay systems are used the target setting should include a wide set of measures, indicating the company's performance in a number of areas that are critical for its success in the future, including non-financial indicators. Any particular measure can be manipulated, but gaming all of the variety of measures is going to be more difficult. The scope for cheating and gaming would reduce further if the core of the measures would focus on collective performance of the company as a whole, rather than individual targets.
- *Our real motivation:* remuneration should not be allowed to destroy our real motivation to do well at our jobs. *Pink* has researched extensively what truly motivates us and three factors stand out: autonomy, mastery and purpose (Pink 2010). A sense of autonomy has a powerful effect on individual performance as a number of behavioral studies indicate (Csikszentmihalyi 1975). Autonomy is not the same as independence. Autonomy is about willful choice, we can be autonomous and choose to co-operate with and depend on others. Its opposite is control. Autonomy requires trust on both sides, from the person who should do the job and from the person who has the hierarchical position to assess the performance. Autonomy leads to engagement, which enhances the ability of people to take responsibility for the job they should perform. Performance based pay is precisely doing the opposite as it seeks to exercise control over performance by rewarding achievement of pre-established targets and takes distrust as its starting point. The second element is striving for mastery. The urge to master something new and engaging appears to be a strong predictor of productivity. If the challenges are set right, not too high when the fear of failing creates anxiety, or too low when we get bored, people can get into flow, continuously improving their mastery. Work becomes play and self-fulfilling: the activity is its own reward. Purpose is the third element. People become particularly motivated if they can contribute to something that is larger than themselves. Chasing personal profit goals and reaching them does not satisfy us, while striving to reach purposes beyond ourselves has a lasting effect on our happiness. Modern happiness studies all indicate that finding purpose in something larger than ourselves is a crucial factor contributing to happiness. *Seligman* describes transcendence as one of the six virtues endorsed by almost all religious and philosophical traditions (Seligman 2008). *Haidt* describes

⁸ Best practice provision II.2.2.

⁹ See for the Dutch Banking Code <http://www.nvb.nl/> and for the Governance Principles adopted by the Verbond van Verzekeraars (Association of Insurers) <http://www.verzekeraars.nl/Publicaties.aspx?publicatieid=200>.

the elevation that stirs a warm emotion in us when we witness moral beauty (Haidt 2006). It is also the source of power and passion that leaders need (Erhard, Jensen, Zaffron, Granger 2010). And again, performance based pay is doing precisely the opposite: it makes our own direct pay-off the driving force of our actions, rather than the larger purposes we could be striving for.

- *Integrity*: substantial performance based pay leads to ubiquitous cheating, which people grow to no longer recognize as such. This is partly because they believe they have acted within the rules and therefore all was fine. This is ignoring a vital element of effectiveness and performance and that is integrity. Integrity in the sense developed by Erhard, Jensen and Zaffron, meaning whole and complete. People have integrity when their word to others is whole and complete. This requires honoring your word, which is either to keep your word and do what you said you would do (at the time and in the manner you said or implied you would) or, as soon as it becomes clear that you will not keep your word (because you cannot or no longer want to keep your word), tell the other who relies on your word that you will not keep it and deal with the problem that you have created for the other by not keeping your word. By honoring your word it remains credible and as a person you remain effective. The same is true for an organization. Acting with integrity enhances productivity and creates value (Erhard, Jensen, Zaffron 2009). Lack of integrity can exist within the boundaries of any set of given rules and also then has the effect of reducing effectiveness and productivity. Substantial performance based pay creates a blind spot for breaches of integrity within the rules. Detailed compliance systems have the same effect: as long as we stay within the rules and procedures we fail to see that there may be massive integrity problems. Removing the blind spot allows us to focus on integrity as an essential ingredient of performance.

Lessons for shareholders, executives and non-executives

Shareholders as principals can suffer when executives as agents ignore their interests. The lesson that performance based pay for executives in its current form provides to shareholders is that it does not reduce the agency problem but exacerbates it. Substantial performance based pay increases the focus of executives on their personal interests to the detriment of all other interests, including the interests of shareholders. Alignment of financial interests has proven to be an illusion.

So what is the alternative for shareholders? The idea that executives of public companies cannot be trusted to take the interests of shareholders sufficiently into account is deeply rooted in the shareholder community and is the key driver for their interest in corporate governance. But it would help if shareholders could see that one of the core reasons for the lack of trust between them and executives is their own lack of engagement with the companies in which they invest. We can debate long about the causes for their lack of engagement – I believe the predominant investment theory, the Modern Portfolio Theory which requires widespread diversification of portfolios, is one of the culprits (Winter 2011). Regardless of the causes, the fact that shareholders are unwilling to engage more deeply and closely is probably as much to blame for the distrust between shareholders and executives as the behavior of executives themselves. Investing in engagement is a much more promising avenue for shareholders to secure the value of their investments than relying on performance based pay for executives to create an illusory alignment of financial interests.

Seeing our worldviews and frames of reference that guide our perception and actions is difficult for all of us. If you also have a strong material interest in maintaining them, like executives have with performance based pay, it becomes all the more difficult. It is therefore no surprise to see that executives struggle to listen, understand and appreciate the criticism on their remuneration and not dismiss it outright, there is simply too much worldview and self-interest in the way. More regulation restricting remuneration in form and scope will not help executives to see their self-created myths on remuneration, it will only confirm them in their view that the politicians, media, trade unions and the public in general don't know what they are talking about. Many theories about leadership have been developed over time, but a crucial commonality is that leadership is not about the success of the leader but of the organization he leads. It is precisely this shift of attention from oneself to the purpose beyond oneself that also gives the leader access to a much deeper level of enduring satisfaction and

happiness. This finding is so basic and yet so easy to ignore, certainly in the face of large personal gains that can be made. "You only see it when you get it," is how Johan Crujff, the famous Dutch soccer player, describes it (Winsemius 2005). It takes courageous leaders to acknowledge that the focus on personal income has not worked well and to develop new, truly motivating stories.

Courage is also what non-executives need. Corporate governance regulation has put them in charge of setting the remuneration of executives. Even if shareholders decide on remuneration policies,¹⁰ it typically is for non-executive directors to design the policy for adoption by shareholders. Non-executives have the authority to transform executive pay and substantially reduce performance based pay. It will be difficult for them to do so as long as both shareholders and executives insist on substantial performance based pay for executives. On the other hand, getting remuneration off the table and ending the constant internal strive with executives over targets, achievements and peer groups and the ever growing external criticism of their decisions should make the job of the average non-executive a whole lot more attractive. That prospect may lead them to start to deconstruct the myths of performance based pay and build new remuneration narratives. With a primary focus on the company's strategy and sustainable performance, on true motivation and integrity. If non-executives can take on this big leadership role, corporate governance will prosper for it.

¹⁰ In the Netherlands shareholders adopt the remuneration policy for executive directors, art.2: 135 Dutch Civil Code. In other jurisdictions shareholders have an advisory vote on the remuneration report which reports on the actual remuneration of executives, such as the UK and, recently, the US following the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

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