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BY GILLES HILARY

It's often said exorbitant executive salaries are robbing shareholders and companies blind. Although this may sometimes seem the case, recent research I conducted with Sudipto Dasgupta (HKUST) and Yuk Ying Chang (Massey University) found that in firms where governance is good, executive compensation is positively correlated with good performance.

In fact, better-paid executives trigger a more negative share price reaction in the firm they leave and are more likely to find a better job after their departure. Their new employer is also likely to perform better after they join. In summary, the system seems to be at least directionally working when a company's governance is effective.

But what is pushing the executive's salary to such high levels? Boards are clearly not trying to get executives to spend an extra hour in the office by paying them more, as many are often workaholics already – although academic research suggests that, left to their own devices, executives are tempted by the "quiet life" in which they become complacent about increasing productivity. I believe there are two key issues board's offering high executive remuneration are trying to address: the ability to attract and retain talent and steer that talent in the right direction.

One of the key issues in terms of talent attraction is fairness, or more exactly perceived fairness. Past a certain level (some say past $75,000 a year) money ceases to bring much additional happiness to an executive. What it does is give people a yardstick to measure their performance, their sense of what they are worth to society against others.

In effect, the level of compensation becomes a summary statistic for how much the board values an individual. Naturally, everyone displays some narcissistic tendencies and wants to feel appreciated. This holds for CEOs too.

However, the existence of higher compensation packages for the happy few may breed resentment with other members of the executive team.

One way of using salary packages to steer executives in the direction desired by boards is by micro-managing them, giving them a blizzard of objectives and matching these tasks with incentives built into their remuneration package.

However, this may result in the package becoming so complex that no one fully understands its properties and complexities, creating the risk of sudden catastrophes through small unfortunate decisions - also known as the "butterfly effect".

There is also the risk that executives can lose the overall perspective and spend more time managing specific Key Performance Indicators (KPI) rather than the true welfare of the firm.

Another point to note is that the chosen KPIs are rarely matched with the corresponding Key Risk Indicators (KRI). This can leads firms to pile on unmanaged and often unknown risk. Risk can be managed by using compensation to encourage executives to take the appropriate level for the organisation. (Naturally, this approach first implies that the board has figured out what this level is. Surprisingly often, this is not the case.)

The firm can then let the executive develop the firm strategy to manage risk, validate it and verify its implementation. Interestingly, boards with strong expertise establish this more sophisticated ways.

For example, compensation committees that have more financial experts rely less on hard financial numbers and are more likely to use discretionary bonuses.

Ongoing research I am conducting with Sterling Huang (Singapore Management University) suggests that organisations in parts of the US where trust among people is higher, rely less on explicit contracts and offer less powerful share-based incentives. Companies in these regions manipulate reporting to a lower degree, engage in less empire building through bad mergers and acquisition and perform better overall.

These results suggest that having an approach based on setting the broad principles, trusting the executives to apply them and (intelligently) verifying ex post that they have been applied may be optimal.

Naturally, building trust is difficult and principle based management does not work with individuals without principles. For directors, there is a fine line between trusting managers and shirking their fiduciary duties. However, directors need to realise that compensation can damage the process of building this trust.

Offering high levels of compensation can damage the social fabric through resentment; by offering specific incentives, it signals that the board is not trusting executives to do the right thing.

Interestingly, other organisations seeking to motivate their members often use symbolic currencies to drive their best people. Soldiers who go beyond the call of duty receive medals, not bonuses.
Academics, are often recognised by their peers, and rarely with lavish financial compensation packages.

Boards can give their executives a sense of worth by highlighting their social contribution to the firm and to society at large.

The trick is to offer the compensation package that makes sense under the circumstances and then remain consistent to the chosen strategy. Easier said than done !

- Gilles Hilary is professor of accounting and control, the Mubadala-chaired professor in corporate governance and strategy, INSEAD Business School