Market Competitiveness vs Motivation
MM&K Remuneration Dinner -6 October 2014

On 6 October 2014, MM&K hosted a dinner for Chairmen, Remuneration Committee Chairs and Chief Executives. This time the discussion was set up in the form of a debate, with the motion that ***"the main goal of directors' remuneration is to pay competitively, not to motivate or incentivise"***.

Before the start of the debate, we took a preliminary vote. Three diners were in favour of the motion and the remaining 14 were against.

Opening arguments

Damien Knight of MM&K proposed the motion and argued that offering competitive earnings (in terms of salary and benefits, bonus and long term incentive opportunity) is the paramount concern of remuneration committees in setting a package which will attract and retain high calibre, high performing executives.

Cliff Weight from MM&K, opposed the motion and argued that pay incentivises and motivates executives and hence companies must reward executives for "pulling the right levers" and not the wrong ones.

Full copies of their speeches are attached.

Discussion

After Damien's and Cliff's opening arguments, the Chairman opened the discussion to the dinner guests. Points made included the following:

Directors in larger companies may be motivated differently from most executives. And it would be wrong if the chief executive were driven by the money. Money is a mark of power.

Pay levels below a 'satisfier' level are clearly demotivating.

The 'right thing' always looks the same as everyone else is doing.

The growth in executive pay so far ahead of average earnings over the past 30 years reflects that there is now so much more value in people at the top of organisations.

Incentives do work. But above a 'tipping point' the amount of reward becomes meaningless. Too much reward may even affect the incentive. The 'tipping point' may, however, be different for different people and can change over time.

Most directors would stay in the same job if they were paid at half the current levels. What matters to them is that they are 'ahead of the pack'. Recognition by external peers plays a strong part in motivation.

The most effective CEOs are not the greediest – in fact the greedier ones are more likely to do something wrong.

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Chief executives are always insecure in their role and there is a desire to protect themselves financially.

Some directors have a very different motivation – eg to 'make an impact on mankind' – and are not motivated by salary. Roger Bannister was not paid to achieve the sub 4-minute mile. A lot of people would continue to work even if they won the lottery.

Motivation below the FTSE 350 and in alternative investment companies is different. For example, directors of private equity ('PE') backed companies are clearly motivated by pay structures. There is no limit to potential rewards – provided performance is achieved. Similarly, in investment banking, base salaries are irrelevant: it is the bonuses which matter.

Larger buyout companies pay market competitive salaries and annual bonuses but the long-term incentive ('LTI') is focused on the exit and the reward opportunity will be much greater than in equivalent-sized listed companies.

In larger listed companies, the benchmark for measuring success is pay relative to peers. But in smaller companies there is more scope for motivating through pay structures – and in PE backed companies it is the key discussion.

Only one out of every seven PE-backed companies is successful, which explains why the potential rewards must be much higher. They attract different personalities who are not risk averse.

The size of directors' rewards is not the most important factor for shareholders.

Before the 'binding vote', there was a weaker connection between the recommendations of voting advisory firms (ABI, RREV, PIRC) and actual votes on directors' remuneration. However, with the binding vote there is now a much strong correlation. Some US institutions are in fact required to follow ISS recommendations. But although ISS plays a useful role, it does not have time to review all remuneration policies properly.

The concept of alignment with shareholders can be a fallacy in a listed company, as many shareholders do not stay with companies even for three years. In contrast, there is 100% alignment between PE investors and management.

Damien Knight and Cliff Weight then summarised the arguments for and against the motion

Final vote

The Chairman called the vote. 5 of those present voted in favour of the motion, with the remaining 12 against.

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Copies of the proposer's and opposer's speeches are attached.

Damien Knight's speech proposing the motion that "the main goal of directors' remuneration is to pay competitively, not to motivate or incentivise."

I am proposing that the main goal of directors' remuneration is to pay competitively, not to motivate or incentivise.

Of course, I'm talking about executive directors; and I have in mind the larger listed companies. The picture's quite different in many private or AIM companies.

When I claim that the main goal is to pay competitively, I mean this is the de facto goal: this is what companies really do.

Of course, they embrace the ideal of incentivisation; they may hope for alignment with shareholders in the long-term; certainly they will say so in the remuneration report. They may even believe it. But a critical look at the history of executive remuneration in the UK tells us this is not what has driven the design and levels of pay.

I am going to offer five pieces of evidence:

1. How the package has grown since the mid 1980s
2. The way companies choose pay markets
3. The real concerns of institutional shareholders
4. The economics of CEO pay in FTSE 100 companies
5. The historical correlation between CEO pay and performance.

First how the package has grown.
I have kept survey statistics on major companies since my time at the Hay Group in 1983. In those days the Chief Executive of an average FTSE 100 or equivalent company sat at the top of a group with as many as 20 layers of management. Internal relativities – both of salary levels and especially of salary increases – dominated company thinking about pay even at board level.

He (almost invariably he) earned a salary and BIK of £150k and a bonus of £38k (26%). He received no long term incentives but significantly had a DB pension benefit of (in reality) about 30% of salary.

In the twenty years up to 2003, the median CEO's total package value had increased by a factor of 15 times. Over the same period, average earnings, the FTSE 100 index, company profits and average earnings all grew by about 4½ times, less than a third of this rate.

What had happened? Why did directors' pay shoot ahead to this extent?

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In fact the whole dynamic of executive pay had changed. Desktop computers, mobile phones and factory automation all allowed companies to slim down hugely, shedding people and organisational layers. As a result, the focus of executive attention moved towards external product markets and capital markets. Executives now measured their value externally.

Other changes fuelled their expectations. In 1984 the Thatcher Government introduced tax efficient share options – within three years most FTSE 100 companies had such a scheme, all granting 4 times emoluments in options. In 1988, the marginal tax rate was reduced to 40% - it started to be worth earning big money because you got to keep it.
Then, throughout the 90's, the amount of pay market information available increased until eventually the Stock Exchange (and, shortly after, the Companies Acts) required listed companies to disclose individual directors' pay packages. So, you could measure you package against your peers.

The concern with competitiveness is also evidenced by the way companies choose pay markets?
I am arguing that this three times increase above company growth and performance came about because boards felt obliged to match the pay market – and to be sure they kept their critically valuable CEO they would choose whatever company size measure necessary to produce the most generous package.

Market capitalisation was – is – a favourite measure. There is something like a 20% hike in CEO pay when you get into the FTSE100. It doesn't seem to matter if your high market cap has nothing to do with the size of the management task or the skills and experience of the person needed to run the company; in other words, nothing to do with the real talent market worth.

What were the institutional shareholders doing while this was happening?
I don't think shareholders' concerns, at heart, are any different now from what they were twenty years ago. In reality, institutional shareholders have two concerns – as a breed they are intermediaries. They have their own clients and they have to be able to defend their stewardship of the company. They don't like to see executives making a lot of money when the shareholder is not doing well. So for them, these huge increases in executive pay had to be justified. They never were of course, not by performance improvements. Investors and the ABI focused their attention on incentive design, particularly share option plan design – and later performance share design – and control of grant levels. But they never succeeded in controlling grant levels either. The (gradually increasing) ABI grant limits for share options quickly became the limits for the performance shares which were individually worth twice as much. In the end, the ABI gave up trying to control grant levels. Companies looked around at competitive practice to determine their own grant limits. Of course, it was all presented as giving high upside to incentivise high performance.

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Next the economics of pay.
Did it matter to shareholders that executives were earning so much? Not a lot. Fat cats were always a concern to the press – the average journalist's pay determines what is a slim cat!

The fact is, good CEOs still come cheap. As part of a study for the CBI, MM&K looked at FTSE 100 CEO pay and shareholder returns over the period from 2000 to 2010. We found that the total value of the CEO package was less than ½% of the increase in shareholder value over the period – about 40 basis points. But they are hardly a passive fund manager – so pretty good value, on average. Given these economics, what real incentive is there for an institutional shareholder, or remuneration committee come to that, to resist the demands of a forceful chief executive with a high perception of his own worth?

But what did our CBI study show about pay increases and performance?
This was the period when companies, chasing yet another incentive to executives to enhance performance, were doubling bonus opportunities in order to defer 50% for three years – on top of the LTIP grants. This was the period when FTSE 100 companies were bringing in multiple measure bonuses, with the net result that they were more likely to pay out.

We found that median TSR growth over the 10 years was 13% per annum; CEO pay also went up by 13% per annum. I don't think this means they earned their 13% - shareholders might expect such returns for the original pay package with no increases in pay. Net profits looked better, with a median annualised increase of 19% - again this is FTSE 100 survivors

But all in all I am afraid that the explosion in executive pay opportunity and payout in large companies has not been matched, generally, by enhanced performance driven by the incentive power of short and long term performance-related pay and share plans. The reality is that large company pay packages have always kept pace with the pay market, and remuneration committees have, above all, been concerned that their executive directors feel well paid in relation to their perceived peers. The Shareholder Spring and the new disclosure regime are not going to change this reality.

I put it to you that all the evidence of the past 30 years is that (whatever companies' ostensible policy may say) the main goal of directors' remuneration is to pay competitively, not to motivate or incentivise.

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Cliff Weight's speech opposing the motion.

- Aristotle Onassis said "If women didn't exist, all the money in the world would have no meaning."
- "Motivation, Motivation, Motivation, what is a man without motivation."[1] I made that quote up myself.
- Mark Twain said "The lack of money is the root of all evil".
- And, of course, Gordon Gekko said "Greed is good."

Four quotes to support my point about motivation.

I'm saying Damien is fighting a lost cause. Whoever heard anyone say "I am really excited that I am being paid competitively? My competitive pay makes me want to jump out of bed in the morning, run to the office and achieve all my key goals." Incentives work!!!

Consider RBS, and BP. RBS was run by Fred the Shred. Performance measures did not measure risk. In fact, risk was rewarded, so risk was incentivised. It was not the only bank with this problem. All the banks over-rewarded short-term performance and used profit figures which turned out to be illusory accounting stuff and nonsense. The FCA and other regulators have demanded that more pay is deferred and contingent on long-term performance. They believe pay motivates. Now, RBS and Barclays are trying to change their culture and looking at remuneration as a key incentive to help make this happen.

BP's safety record before the Deepwater disaster was far worse than the other oil majors. Their incentive plans now have safety as a key metric. They did not before. Their board now clearly thinks remuneration incentivises behaviour, although they had to learn the hard way.

Yes, I argue pay motivates.

Money is not the only motivator. Professor John Kay, in the Kay Review Report summarised it well:

'Incentives matter: not because, as some people crudely think, financial rewards are the only human motivation (although there are some people of whom that is true, and many of them are to be found in the financial sector). Most people have more complex goals, but they generally behave in line with the values and aspirations of the environment in which they find themselves. We must create cultures in which business and finance can work together to create high performing companies and earn returns for savers on a sustainable basis.'

The crunch question about motivation and money is this: "If you won the lottery tomorrow, would you still carry on working in your current job?" The honest answer for almost everyone is no! So we have to recognise that people go to work for the money. They are motivated by

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[1] Reputation, reputation, reputation! O, I have lost my reputation! I have lost the immortal part of myself, and what remains is bestial. WILLIAM SHAKESPEARE, *Othello*

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their desire for money. They will do things so as to get more money. So, we must make sure that the reward systems reward people for doing the right things.

That was the conclusion of Jim Finkelstein with Mary Gavin in their book FUSE[2] about combining the knowledge, experience and perseverance of 20th century workplaces with the speed, digital intelligence and global view of 21st century workforces, to ignite a high-productivity and profitable future for our organisations.

Alfie Kohn said 'It is difficult to overstate the extent to which most managers believe in the redemptive power of rewards.' Whether you agree with Alfie Kohn or not, you do have to acknowledge that most managers think pay motivates.

The seminal piece of research was by Jensen and Murphy, published in the Harvard Business Review 1989 article, 'Performance pay and top management incentives'. They concluded that CEOs were inadequately rewarded for increasing the returns to shareholders, and instead ran organisations as if they were their own empire. This was ground-breaking stuff and was seized upon by many and led to significantly increased equity incentives, principally via share options.

Let's look at the psychology of Motivation. It is complex. Let's have a quick review of the theory. We have all heard of Maslow's needs.

Herzberg refined Maslow's ideas into those items that are satisfiers (but not motivators) and other factors, the absence of which leads to demotivation.

McGregor thought you could separate employees into Theory X, those who do not like work and only do what they have to, and Theory Y, those who are self-directed and try to do their best.

The Hawthorne effect noted that when lighting was changed, performance increased, i.e. attention and interest from management leads to improved performance. So, if you change the incentive schemes the performance will improve.

Victor Vroom (I love the name) propounded the most widely accepted theory: motivation = expectancy x value of rewards.

Expectancy theory, stresses and focuses on outcomes, and not on needs, unlike Maslow and Herzberg. The theory states that the intensity of a tendency to perform in a particular manner

[2]See http://www.fusethebook.com/about-the-book/ . I was asked if this is a good reference and given this alternative view. The book is about motivation of junior staff against middle managers. It appears to state that money is less important to the younger generation whereas I am arguing that it is very important to the CEOs/top execs. (It might be a better reference in 20-30 years' time if these younger employees reach the top positions!) Furthermore the 'crunch' question may not be relevant. These CEOs do win the lottery and get millions – but they don't stop working; they carry on to try to get even more – especially those in private equity. These CEOs mix with other like-minded and rich/powerful people. The lottery winner by contrast is suddenly forced out of his depth in his social group – the wealth contrast is too great for them to be able to work or socialise with their former colleagues.

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is dependent on the intensity of an expectation that the performance will be followed by a definite outcome and on the appeal of the outcome to the individual.

Expectancy theory concentrates on the following three relationships:

- Effort-performance relationship: What is the likelihood that the individual's effort be recognised in his performance appraisal? (e.g. I win the debate)
- Performance-reward relationship: the extent to which the employee believes that getting a good performance appraisal leads to organisational rewards. (e.g. My CEO will buy me a brandy or give me a big bonus)
- Rewards-personal goals relationship: the attractiveness or appeal of the potential reward to the individual. (e.g. I would quite like a brandy)

Vroom was of the view that employees consciously decide whether or not to perform at the job. This decision solely depended on the employee's motivation level which in turn depends on three factors of expectancy, valence and instrumentality.

Edwin Locke's Goal Setting theory states that setting specific, clear pronounced objectives helped motivation, but vague objectives demotivate. Locke's goal-setting theory is widely acknowledged as correct and useful for motivating employees.

David McClelland's theory is particularly pertinent to CEOs and says people have needs for Power, Affiliation and Achievement. This theory says that there are three main needs – the power, in which the main motivation is the chance to manage others; the affiliation, in which the motivation is the cooperative and harmonious environment; and the achievement, in which the motivation is the challenge and feedback.

McClelland in the Harvard Business Review article 'Power is the Great Motivator' concluded 'when it comes to managing big companies, the desire for power – that is a manager's desire to have an impact, to be strong and influential – is more important than the need to get things done or the wish to be liked.'

Which leads me to my concluding point, which is about Proxy Agency theory. Executive managers are the agents of the shareholders and have to be incentivised to behave in the best long term interests of the shareholders.

Our conclusions

Benchmarking the competitiveness of remuneration is an important part of the process. Without "fair" levels of pay, dissatisfaction and demotivation arise.

But motivation, alignment and incentivisation are the most important goals of directors' remuneration. The choice of performance measures and the targets associated with each measure is, therefore, absolutely crucial.

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