Event Report: ‘Market or Racket: do we need a new approach to executive pay?’

Academic Introduction – Executive Pay: Paying for Performance

Alex Edmans, Academic Director, CCG and Professor of Finance, London Business School

Alex Edmans gave an academic introduction examining whether pay is linked to performance. He discussed four key topics; whether pay is linked to performance, whether executive pay should be linked to performance, whether pay is linked to the right measures of performance, and how executive pay can be improved.

On the first topic, Edmans began by outlining academic evidence that claims to show that pay is not linked to performance. He referred to the earlier Lancaster study cited by Stefan Stern, which concluded that the link was negligible. Moreover, he pointed out that this was not the only report that claimed this finding. The House of Commons BEIS Committee “Executive rewards: paying for success” report released in 2019 claimed:

“There is no perceivable link between corporate financial performance and the sums paid out to CEOs. There is academic evidence to suggest that this link is in any case statistically weak or non-existent.”

Additionally, a report by Chris Philp MP, entitled ‘Ending the ownerless corporation and controlling executive pay,’ and endorsed by Neil Woodford and Lord Paul Myners, argued:

“There is clear evidence that high CEO pay is no longer strongly associated with performance, and two academic studies clearly show in fact high CEO pay negatively correlates with performance.”

Edmans said that people acted on the basis of this report and a year later, Woodford said he would scrap incentives within his organisation based on evidence that they do not work. Edmans emphasised that you cannot ascribe causation to the later effects (Woodford’s fund being wound up after hefty losses) but that it suggests removing incentives might not be the panacea that is argued.

The audience was encouraged to take a closer look at the evidence presented. Edmans explained that there is a huge range in quality of academic evidence and whether a paper has undergone the peer review process is a critical indicator of quality. The peer review process involves scrutiny by world-leading experts on the topic, and spending several years perfecting your methodology in response to their concerns. The Lancaster paper was never published, likely because it contained a very basic error – shared by other studies which claim to find no link between pay and performance. The studies only consider the change in ‘flow based’ pay (e.g. salaries and bonuses), which indeed vary little with performance. Edmans gave the example of Steve Jobs who got paid $1 a year at Apple regardless of how the company performed. However, the vast majority of incentives do not come from the flow of new pay, but the stock of existing wealth that you have. Jobs had hundreds of millions of dollars in his company and this would have reduced substantially if Apple had underperformed. Looking in general at the data, Edmans said that if there is a 10% fall in a company’s stock price, that is equivalent to a pay cut of around $10 million in the US or about £1.2 million in the UK. This shows that CEOs should not be indifferent to poor performance and are indeed held accountable. Therefore, Edmans argued that pay is indeed linked to performance.

Turning to the second point, whether pay should be linked to performance, Edmans agreed with Dan Cable that intrinsic motivation is important. However, the critical question is not whether intrinsic motivation exists but whether extrinsic motivation through money reinforces it or crowds it out. He
referenced a famous academic paper entitled “On the Folly of Rewarding ‘A’ While Hoping for ‘B’” which claims that it does. If you pay teachers for high test scores, they may teach to the test rather than trying to instil a love of learning. However, Edmans stressed that these studies focus on lower level employees where it is difficult to get a measure of performance. With CEOs, there is a reasonably comprehensive measure of performance – the long-term stock price – which captures most channels through which the CEO affects value. This includes employee satisfaction, treating the environment well, or delivery on material ESG dimensions. Giving value to stakeholders across the board indiscriminately does not necessarily add value, but does if done so in a discerning way.

Edmans referenced a study by Von Lilienfeld-Toal and Ruenzi which demonstrates the benefits of equity-based pay. It compared companies where the CEO holds a lot of shares in her firm with companies where the CEO holds few shares in her firm. The former beat the latter by four to ten percentage points per year, and further tests suggested that it was causation rather than correlation.

Edmans moved to the third point of whether pay is linked to the right measures of performance. He acknowledged that the stock price is the wrong measure if it is measured in the short term. He cited his paper with Vivian Fang and Katharina Lewellen which showed that, when CEOs are likely to sell their shares, because their equity is vesting, they significantly cut investment, and just meet earnings targets. So the CEOs are more likely to be focused on hitting quarterly earnings numbers at the expense of long term growth. Edmans also cited a paper by Flammer and Bansal which shows that, when shareholders pass proposals to put in long term incentives into a company, profitability falls in the short term but increases in the long term. Moreover, stakeholder value improves – measures of how a company treats the environment, customers, society and employees go up – and innovation rises as well.

Finally, Edmans moved to how pay can be improved. He suggested that CEOs must be encouraged to think about the long term rather than short term measures. The simplest way to do this is to replace long term incentive plans with restricted stock. This gives not just want rewards on upside, but also punishment on downside. If the CEO has shares, those would go down if performance is poor in the long term. Most importantly, perhaps this is something that can be given to all employees. Edmans agreed with Rachel Reeves that, if a company does well, it is likely due not just to the CEO but because of the efforts of all those working within the company. If you give shares to the CEO, you can also give them to the wider workforce. Edmans gave the example of The Weir Group which gave shares to employees at the same time as it did to executives. Edmans said, “if you give shares to everybody, that’s a way of making sure everybody benefits from a growing pie.”

Edmans directed the audience to The Purposeful Company Study on Deferred Shares, which looks at the evidence and practitioner views on implementing restricted shares and what the downsides are. Edmans has also just written a book called “Grow the Pie: How Great Companies Deliver Both Purpose and Profit” which includes a chapter dedicated to executive pay. He has also made further information on this topic available on the CCG website.