Before moving on, it is important to address the key-terms discussed in this article. “Executive compensation” is going to be used as a rather broadly defined concept, including (but not limited to) bonuses, stock options, and even pensions. Their uniting feature is that the company rewards their executives in this way on the basis of company performance (in theory, at least). It is also pivotal to state clearly what I mean by “Board” and “executive”. The former is the body that the stockholders elect to guard their common interest. The latter is an individual chosen by the Board to carry out the day-to-day running of the company. Executives are not members of the Board, but rather their employees.

Executive compensation is of course a very important topic for Boards and the stockholders that they ideally represent. In light of recent events it has become clear that it is also an important topic for politicians and the voters that they ideally represent. The thought has been widespread that if the Board wants to pay their executives ridiculous super-salaries, then that is their prerogative. The shareholders have invested their own money, the Board is their duly elected agent, and if things turn sour it will be the shareholders who carry the loss. Everybody else should just mind their own business. But as we gaze upon the stage today and realize that in Iceland, as well as in many other countries, company ownership is strangely reminiscent of North Korea, then it becomes obvious that executive compensation is in no way a private affair for the Board. Increasingly companies must consider factors like fairness, moderation, and take notice of the interest of other workers, shareholders, and the general public.

Although popular in many other countries, executive super-salary is a concept that only recently invaded the Icelandic psyche. The underlying notion is that by linking the salaries of the executive with the performance of the company, the company is effectively being put on autopilot and the Board members can with good conscience withdraw to improve their golfing handicap. A somewhat perversely socialistic idea of rewarding those that create the wealth and not just those providing the capital (Torrington & Hall, 1998). The obvious difference between these groups of people is that owners and investors bring capital into the company and their gains are proportional to their investment. Executives on the other hand, wager nothing. They have nothing to lose. It does not take profound knowledge of human nature to see that this kind of mutant Marxism will stimulate risk-taking by executives, who have much to gain from the company growing fast, but nothing to lose if things get tough. Some companies have responded to this conundrum by having executives taking loans to buy shares, a practice that I will discuss later in more detail.

But can it really be so that if the company puts forth demanding goals for growth and promises of bountiful bonuses if they are achieved, then no further governance is required? Of course not. Things are much more complicated. The first issue to be resolved is the question: “Which are the appropriate goals?” As shareholders own shares, it might seem logical to tie the goals of the company to share-price. But that is not always the best indicator of a company’s performance. Often shares in riskier businesses rise much higher at a given period than others. And the stock market is not always very sensible. Its behaviour usually seems more related to the mentality of herds rather than the exercise of common sense. Also, in very large companies, it can be exceedingly difficult for executives to affect their actual workings with their contribution. The simplest way for an executive to raise share-price is simply to buy other companies. In its short-sightedness, the market usually always responds to such a measure in a favourable manner. Another short-sighted move the market favours is laying off people. Both of these steps by and large cause share-prices to rise in the short-term. A time period surprisingly often just long enough for the executives to cash in their bonuses. In the aftermath, we find companies that are larger and more complicated or with fewer people on the payroll. The net result of such exercises can be rather slender.

The rather problematic relationship between share-price and performance is well known and has been tackled by some companies by tying bonuses to more numerous and varied goals. However, research has shown that the more complicated the goals become, the easier it seems for the executives to attain them almost automatically without any additional effort. Complex goals show high correlation with the amount of bonuses being paid out, but no correlation with the actual performance of the company. The result is an uncoupling from the interest of shareholders, which has been clearly demonstrated by the fact that the companies that have required the most government assistance in the crisis, have at the same time been contractually obligated to pay out the highest bonuses.

A prime example of the insanity that this culture of executive pampering has led to, tells of a reputed British banker. The man in charge of the Royal Bank of Scotland, who filled the list of the worst bankers in history (a list all too familiar to Icelanders), retired at the tender age of 50 with an annual pension of £703 thousand for the remainder of his life. This sounds quite extraordinary given the fact that Sir Fred Goodwin was responsible for major catastrophes such as the acquisition of the ABN Amro bank that resulted in RBS posting the largest loss by any company in the history of Britain, a staggering £24 billion. Even for an Icelander, accustomed to our banking wizards losing hefty sums, Sir Fred’s capacities in annihilating the balance sheet seem almost perversely admirable. This generous pension scheme had been approved by the Board and was in fact irretrievable despite the obvious and grievous harm that Goodwin had caused.

The eminent Canadian economist John Kenneth Galbraith once said that “the salary of the chief executive of a large corporation is not a market award for achievement. It is frequently in the nature of a warm personal gesture by the individual to himself". As much as I admire Galbraith, I have to disagree with him on this point. First of all, I do think the market determines executive pay and compensations. The problem is that the market is sometimes absolutely brainless. Secondly it is almost never within the power of the executive to decide upon his salaries, but rather it is the Board's decision. And it is there that the problem lies, and there were improvements can be realized. Granted, the development over the last few years has not been very encouraging. The salaries of top executives in Britain for example, have grown from being 17-times higher than the average subordinate, to 75-times higher in only the last 20 years. And please note that I am talking about average, i.e. not minimum subordinate wages. At the heart of this problem lies the familiar principal-agent dilemma. In line with Galbraith, it is obvious to point out that the interests of the company are likely to be quite different from the interests of the executive. Performance-basing executive compensation should strive toward giving (all) the shareholders the highest return on their investment. That is why it is extremely important that the performance-measures used accurately reflect this. It is for example critical to factor in the time-issue. There is an inherent danger that the long-term interests of the shareholders will be forfeited in exchange for the short-term interest of the executives. One such problem of time is linking executive compensation with stock-price. The value of a stock is based on expectation of future performance of a publicly traded company. But creating expectation of performance is quite different from actually delivering performance.

In this context it becomes very interesting to look at the changes in the role of the executive during the past decade or so in Iceland. It has moved from simply being on top of the employee pecking-order, to becoming compensated as an owner or a risk-seeking investor. Malcolm Gladwell provided an excellent account of the collapse of Enron in an article in The New Yorker in 2002. To an Icelander his observations sound eerily familiar. He maintains that the interests of the shareholders had given way to the interests of the company stars; a culture driven by management consulting firms, whose employees often graduate to executive positions in other companies (including Icelandic ones). Traditional attributes such as experience, education and seniority were redundant at Enron and replaced by inordinately rewarding the company's stars. All of this was also part of the mantra being repeated for the Icelandic public when it dared to question the raison d'être for the humongous compensations being awarded to our home-grown finance stars. Following extensive deregulation and privatization it took these financial super-beings six years to bankrupt the whole country (interesting for investors to note that crisis unusually often follows deregulation and privatization).
But what is the actual correlation between bonuses and company performance? If we give way to cynicism, we might claim it to be extraordinarily strong: the higher the bonuses, the

more spectacular the bankruptcy! But if we are advisors in some company's remuneration committee, which would be the proper advice regarding the adoption of bonuses? Well, we could state that research shows that there is a weak but positive correlation between bonuses and company performance. The correlation coefficient is between 0.09 and 0.11. But what really stands out when one reviews the literature on executive compensation is that scientific research in the field is almost non-existing. Given the cost that the companies incur, this comes as a surprise. The proponents of these compensation schemes (a position sure to be rewarded with a bounty of invited speaking opportunities at exotic locations) frequently claim that one needs only to look at the annual outcome of companies to see that the more successful ones pay out more bonuses and options. Of course to anyone with a modicum of sense the fact that more lucrative companies pay higher salaries says absolutely nothing else than that. There is nothing to indicate a causal relationship.

What about stock-option contracts in which the employees have to take loans to buy shares and are then stuck in a huge gamble with their private fortunes for two to three years or longer? This was a common practice within the Icelandic financial sector and landed several executives with personal debts worthy of a small country. The laws applying to companies serve to limit the responsibility of shareholders. So stock-option contracts that require executives to take on such personal risks, actually counter the law.

Even though the stated purpose of Boards putting forth bonuses is to make the executives think more like owners, reality may contradict this assumption. Basic theories in portfolio management suggest that it would be in the executives' own best interest, when they receive additional shares in the company, to sell what they had before. By doing that they would minimize the risk that comes from having too much capital invested in a single company. The risk of this "single company exposure" has indeed more to do with share-owning executives than with other investors, since the executives' employment status is also linked to the company performance. Accordingly, studies by Ofek and Yermack (2000) show that executives that own shares in their company, usually sell them upon receiving new stock options. That will of course reduce the anticipated incentive the Board has in mind when giving out additional options.

Bonuses have to be considered in lieu of co-workers and cooperation within the company. Bonuses are by definition assigned to individuals. Their role is to further individual performance. That is in itself a conundrum, since we all realize that an individual by himself will accomplish very little within a company. The entirety of his accomplishment is indeed based upon his opportunity to seek help from his co-workers. However, if my supervisor calls me day and night, holidays not excluded, and requires me to work far beyond my contractual obligations, then of course it will leave a sour taste to see him walk away at the end of the year with huge bonuses while I am left with huge black rings under my eyes. Bonuses have to be fair with regards to co-workers. This is evident to most companies and those that dish out the heftiest bonuses are in the habit of ensuring that some crumbs are left for the plebeians. The overall result is often that married with increased risk-seeking, the companies' overall salaries swell. Unfair bonuses can actually demotivate and destroy morale. In that way they can actually counteract their initial purpose.

An important and largely ignored issue is that of repeated bonuses. There is no question that most people would work like mad and increase their performance, if offered to double their salaries. If offered such doubling again the following year, again most people would readily accept and some people might be able to muster a slightly better performance (not twofold though). The bonus offered in year number three is however, not likely to do anything to enhance your performance, and indeed it is very likely that performance will actually be dwindling, if not for other reasons then exhaustion. Also suffering from exhaustion will be your personal relationships, health and all the really important things. In these situations, bonuses only work in keeping people, but do not have any effect on performance. And this is a key issue. In fact executive bonuses have been intended more to keep them put, rather than increasing their performance. But why do Boards pump more and more money into executives when they know that their performance is unlikely to improve? At some level it is due to a common attribution-error that has permeated both popular and academic writings on the subject. We all have a tendency to take the credit for our successes, whilst blaming our failures on the environment. In the almost unprecedented bubble-atmosphere we have been experiencing in the last few years, where almost all shares increase logarithmically in value no matter what, the Board which actually might have very limited true knowledge of the workings of the company, tends to take immeasurable pride in how shrewd they were in bringing in and/or keeping their star management-team. And thereby completely overlooking the fact that the success is simply driven by an overabundance of cheap credit. It takes strong bones to survive good days and in such a favourable atmosphere it is pivotal that the Board stays grounded in its decisions on remunerations.

A reasonable person will determine a certain degree of fairness between efforts at the workplace and the pay received for those efforts. We instinctively know when we are being treated fairly in that respect. And if we feel underappreciated paywise, we tend to reduce the level of output. Similarly, if given a raise we are likely to contribute a little more. However, if we are receiving, say, 240 times the pay that our lowest-paid co-worker is taking home, then we experience something of a crisis, because we can no longer justify the amount that we get. Still, human beings are, most often regrettably, very well endowed with all sorts of ways to justify themselves. So if we are being overpaid, we tend to justify it by manipulating our own sense of fairness. Instead of focusing on the relationship between your own pay-cheque and your contribution, you start looking at your pay in relation to what others are being paid. Is anyone less competent than you being paid the same amount? Or is someone just as competent as you getting paid more? Since the links to performance have been effectively severed, the end result is just higher wages without any increase in output. This practice then rubs off on other companies that will experience mounting pressure from their executives to play along.

But what happens with executives with stock options and bonus-contracts if the company is doing poorly? Ideally, motivated by their own personal gain, they should increase their efforts. However, that rarely happens. They will experience more stress, but their performance will not improve. The time they spend ogling the falling share prices is not productive. This applies specifically to those executives that have taken loans to finance their stock option deals. If the company is not performing, these people are not looking at lost bonus opportunities but actual personal loss. This is a very dubious way of managing performance.

I suspect a lot of people had high hopes in the aftermath of the current crises, that the super-salaries of executives would become a thing of the past. These hopes are likely to be crushed. I refer you to the strongest laws of economic theory, the bounty of greed and stupidity. The present crisis is neither the first nor the last. The first thing that surfaced from underneath the rubble this time was greed. Bankers are presently waiting to lock in even higher bonuses and options than ever before. Courtesy of the common tax-payer. The reason for these monstrous salaries, is said to be that the banks are in dire need to compensate their best employees, otherwise they may seek employment elsewhere (although where exactly is not fully clear).

But performance-based pay is not altogether a bad concept. It works well in various factories, for skilled workers and even among us lazy, no-good academics. However, I think it is pivotal to rein in the madness that has been going on amongst executives. This is the responsibility of the Board. But since it is the shareholders that select the Board, the ultimate responsibility lies with them. It is in fact noticeable how easily the Boards of many companies have been able to face public outcry.

It is absolutely necessary to keep in mind when deciding upon bonuses, that they should have a predetermined range. For example, that nothing is paid out before 80% of the goals are reached, increasing gradually until nothing extra is paid if 120% of the goals are reached. A part of the problem with bonuses has been a lack of cap. Share prices for example have no upper limit, and I think it really tests the individual to have his/her performance linked to that sort of compensation.

Executive bonuses should also extend longer into the future, even years after the person has given up his/her job. This might better guard against executives cashing out from decaying companies. In the case of stock options, it may prove valuable to put more consideration on the buying price for the executive. Some companies have supplied their executives with stocks below market value, which effectively generates profit immediately. Others have been supplied on the value that they were on the contract day. But isn't in fact more proper to offer stock to executives at a price that is higher than the market is paying on the contract day? That would most likely guarantee that the executive would need to perform better.

The trading of company stocks is based on trust. The whole crisis for that matter is simply a case of sudden depletion of this most precious asset. People buying stocks must be able to absolutely trust that executives, Board members and accountants do their best to look after the interest of all shareholders. This is especially relevant for small investors since they often do not have the resources or the knowledge to pour over company statistics. Since portfolio theory would recommend the small investor to diversify, it places him in even more problems with monitoring his investment.

In Iceland there has lately been a lot of interest in calling to the table psychologists and psychiatrists to share their insights into sociopathic personalities. This in my view can only serve to muddle the discussion and divert it in unproductive directions. True, mental professionals have long since known that the ratio of sociopathic personalities in the top layers of business is much higher than in the general population, although the exact numbers are a matter of some debate. But if one looks at the definition of such individuals, for example in Cangemi (2010), it is not difficult to see how they become valuable in the environment of modern business. They are callous, focused, have a strong desire to destroy their competitors, delight in inflicting pain, and have remorseless willingness to do whatever it takes to reach their goals. However, I find the current obsession with sociopaths in business to miss the point. It was not that the ratio of these people had dramatically risen in the preamble to the crisis. And all the people that either partook in these dodgy dealings or failed to correctly signal what we were obviously heading toward, were not sociopaths. The cause of the crisis was not a personality issue, but rather one of politics and shoddy systems. And by focusing on personality we risk averting our eyes from, and neglect the real issues that need attention. Anyone who reads history knows that sociopaths have filled the top layer of society from its very beginning. So nothing new there. But focusing on the role of the sociopath in bringing about the crisis also alleviates responsibilities. It somehow brings the message that we have been attacked by criminals, instead of building up a failed system. Greed and stupidity are universal personality trends, not disorders of the few.

The principal-agent dilemma needs to be recognized as a problem of Boards of companies as well as their executives. The Board is the highest authority of the company excluding the shareholders themselves. It fails mainly due to two reasons. Firstly, the owners can be short-sighted and only on the lookout for quick and easy gain. In that case they will soon leave the company a hollow shell having stripped its assets or engaged in excessive borrowing. In Iceland this was a common practice leading up to the crash, and even glorified in the popular press as a part of the Icelandic business genius. Secondly, the Board may be representing the owners by proxy. This happens when the Board is comprised of representatives from pension funds, banks, hedge funds et cetera. Funnily enough, one of the most durable mantra of Capitalist thinking is that people take better care of their own money than other people's. However, in practice this is rarely the case. Such arrangements really magnify the principal-agent dilemma, and are probably the most important issue to address if we are to regain an acceptable level of trust and sanity within the financial system.

In restructuring our system of finance, business and politics, we would be well advised to head the tried and tested adage; hope for the best but prepare for the worst. An executive will not think like an owner just because he's being compensated as one. The most dramatic improvement to the financial system would be realized if we could get the owners to think like owners, i.e. to guard the interest of the company in a longer term. This is the really important principal-agent problem, because at the end of the day it's the decisions made by the Boards, not executives that sink companies.

Conflict of interest

Dr. Arnarsson would like to state that he was himself a recipient of stock options in his former employment within international pharma.

References

Cangemi, J. P. (2010) Sociopaths In High Places. Organization Development Journal. 15 Feb, 2010. http://findarticles.com/p/articles/mi_qa5427/is_200907/ai_n32127546

Gladwell M. (2002). The Talent Myth – Are smart people overrated? The New Yorker, July 22, 2002

Ofek E. & Yermack D (2000). Taking stock: Equity-based compensation and the evolution of managerial ownership. *Journal of Finance, 55*, 1367-1384

Torrington D. & Hall L (1998). *Human Resource Management* 4. ed. Prentice Hall: London.

Share this:

- Share