

REVIEW OF BEBCHUK AND FRIED 'PAY WITHOUT PERFORMANCE'

Trevor Buck

Loughborough University

Lucian Bebchuk and Jesse Fried (2004). **Pay Without Performance: The Unfulfilled Promise of Executive Remuneration.** Harvard University Press, Cambridge, MA: £16.95 hbk. ISBN 0-674-01655-3.

This reasonably priced book represents very good value. It collects and develops the authors' ideas on executive pay, already published in widely cited papers in prominent law and economics journals. Besides providing an up-to-date and comprehensive review of executive pay practices in the USA, Bebchuk and Fried (BF) propose an entirely new paradigm for their analysis, intended to replace the conventional agency perspective.

While executives' alleged excesses have been a regular feature in the popular press, academic research has mainly been based on agency theory and focused on the narrow question of whether the sensitivity and elasticity of pay with respect to firm performance has been high or low. Agency theory sees the executive pay package as an opportunity for shareholders to align the interests of shareholders and with those of salaried senior managers, providing them with an incentive to raise shareholder value. The dominant form of executive reward, the executive share (or stock) option, effectively introduces a formula whereby share-price performance determines executive pay. In these circumstances, the calculated sensitivities simply reflect the formula and do little to identify the impact of incentives and the motivation for executives to act like shareholders.

BF relegate their account of this traditional literature to only a few pages and propose the total replacement of agency theory with their managerial power perspective. Readers must judge for themselves whether they succeed. Executives may be seen as selling their services to "the firm" (whatever that means), and whenever a commodity is bought and sold, the relative bargaining power of buyers and sellers helps to determine price. With executive pay, the board of directors buy executives and pay packages are the outcome. Hence, what is different about this market?

BF simply assert that there is very little evidence of markets at work here, because executives effectively control boards. As buyers *and* sellers, they can crank up levels of pay, avoiding performance-contingent elements that require them to supply extra effort and thus guaranteeing themselves risk-free rewards. The only effective constraint on this rigged market is the danger of "outrage" in

the press, which can threaten the reputation of executives and their long-term career prospects.

However, outrage is limited by the limited disclosure of information on executive pay, and BF note that executives deploy a wide range of “camouflage” to conceal their high levels of guaranteed pay, i.e. (p. 67) “. . . the designers of compensation plans can limit outside criticism and outrage by dressing, packaging or hiding-in short, camouflaging-rent extraction.” Hence, the market (what BF call arm’s-length contracting) is rigged, *and* the outcomes are concealed.

Such camouflage can include, for example, soft performance conditions attached to bonuses and options, but this softness can be concealed from shareholders and the press by smokescreens involving long lists of comparator groups of firms, etc. The use of supposedly neutral remuneration consultants in package design gives the whole process a gloss of respectability. (In the UK, I once asked a consultant about his real work. “I get as much pay for my clients as possible without them appearing in the financial pages of the Mail on Sunday,” he replied candidly.)

While stating their case, BF make a number of common-sense observations that had not occurred to me before in as many words. For example (p. 87), boards want departing CEOs to be friends, not enemies (p. 71) two-thirds [sic] of the largest 1000 corporations in the USA report that they have beaten the performance of their peers, and (p. 124) executive bonus is often tied to whether an executive meets a budget. Finally, (p. 54) internal promotion for CEOs is impossible. They can only boost their own pay or seek to be CEO of a larger or more prestigious firm.

But, beyond these nice observations, is the BF approach so revolutionary and paradigm-replacing? Like a good map, an effective theory depends on the use to which it is being put. Certainly, the managerial power perspective shifts the focus of the analysis from shareholder principals to executives, but agency theorists would argue that allegedly excessive rewards that are insufficiently tied to performance are merely the outcome of weak governance. Indeed, BF’s policy prescriptions are relatively orthodox: strengthen the buying power of shareholders and weaken the selling power of executives. This can be achieved, for example, by keeping CEOs away from director nomination committees and by having specific shareholder votes on executive pay at Annual General Meetings (AGM). Above all, non-executive directors (p. 207) should be more independent of executives and less independent of shareholders. This implies awarding company shares to Non-executive Director (NED).

In any case, the BF analysis only applies to the USA. The UK has certainly avoided some of the worst examples of executive excesses (e.g. the re-pricing of underwater options) and many of the BF reforms to invigorate AGMs have already been used here. Towers Perrin in 2002 estimated that total CEO rewards in large firms averaged \$1932,000 in the USA but only \$669,000 in the UK. This represented a multiple of the average pay for hourly-paid employees in the USA of 531 compared with 25 in the UK. Hence, BF’s concerns are nothing to worry about here.

Certainly, self-regulation in the UK, involving the Stock Exchange, the accountancy profession and associations of institutional investors, has yielded tighter

controls on options and long-term incentive plans. At the same time, however, these controls may offer new opportunities for camouflage, as the complexity of schemes may make it easier to hide softness in the details of pay packages. Although long-term rewards are subject to relatively tight controls, swings of fashionable outrage may not provide a steady constraint on executives. For example, executive bonuses (amounting, on average, to over 40% of salaries) have received little attention in the UK, and most of us are familiar with obscene levels of recent severance payments for UK executives.

BF *do* have relevance for the UK. This supposed specialist in executive pay research found BF's book to be a neat and profound analysis of executive pay practices that was always insightful and well-referenced, although it did ignore my work totally! It is strongly recommended for MBA and other Masters students and even for undergraduates.