Money talks, passion sings
Designing fair management reward systems

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Executive compensation packages are currently under heavy fire. Both legislators and businesses are urgently seeking ways of preventing excesses like those witnessed in the wake of the banking crisis. There is no shortage of regulatory proposals, but they do not look particularly promising. Because as companies strive to recruit the high-caliber executives who will help them master these turbulent times, they are naturally keen to offer attractive rewards. What counts here, though, is the ability to recognize what really drives human behavior and in which parameters there is genuine correlation between pay and lasting performance.

LAST DECEMBER, one of us attended one of the most important CEO conferences in the United States, where top leaders of some of the largest companies on earth had met privately to discuss a series of burning issues. While the agenda covered extremely important and urgent topics, including an update from the Treasury by Henry Paulson and a discussion of the first 100 days for the new administration, probably the most passionate session was the one on CEO compensation. It was also the one that evidenced the highest level of confusion.

This passion and confusion goes hand-in-hand with unprecedented levels of anger among the general public regarding compensation and severance packages for CEOs in general, and for the CEOs of investment houses, banks, and mortgage lenders in particular. Understandably, when the total amount of the bailout in the United States alone will amount to a few trillion US$, people simply cannot understand the bonuses at A.I.G., or how someone like Richard Fuld, who oversaw Lehman Brothers' capitulation, could make US$34 million in 2007 and collect almost half a billion dollars from selling his stocks before they became worthless. His case and many others have provoked a public outcry against such compensation and severance packages, when many taxpayers will have to work five or even ten years longer to make up for their pension fund losses, while also picking up the tab for the bailout.

Similar reactions are spreading all over the world, with a number of countries in addition to the U.S. – including

France, Germany, The Netherlands, Sweden, Switzerland, and the UK – already limiting (or proposing to limit) executive compensation in firms benefiting from national rescue packages.The raft of options being discussed, and in some cases already underway, includes salary caps, limits on corporate tax deductions on executive pay, limits on golden parachutes, clawback clauses for executives at companies benefiting from the bailout, initiatives to discourage excessive risk taking, and far more stringent general oversight and regulation concerning pay practices.

Understandable as these reactions may be, they do not constitute an intelligent response to what is a major problem. The very severity of the global crisis means that, now more than ever, the best managers must be attracted to the most critical positions, retained, and motivated. With this in mind, most of the public initiatives introduced to date are, in our view, highly questionable.

First, there is a significant level of ignorance regarding the findings of research into what really drives human behavior, including the role of intrinsic versus extrinsic motivation, and regarding the findings of research linking compensation to performance.

Second, most public initiatives are likely to be counterproductive: There will no longer be a level playing field. Companies impacted by the imposed measures will find it harder to attract and retain quality executives when they need them most. In some countries they will also be burdened with higher tax payments related to executive pay, which is ironic in that it will further punish the shareholders. High-caliber executives may be enticed to move into other industries or countries with fewer compensation restrictions. And finally, some forms of regulation may directly backfire, as was the case with America's infamous US$1 million cap on CEO pay in the 1990s, which led to the dangerous stock option culture. To attract, retain, and motivate the best in these challenging times, we need to observe several practices:

Understand the basics of motivation. The stronger source of motivation is internal and not external, even

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though external incentives can help, as long as they are applied to the right people and properly aligned with internal motivators. However, external motivators are tricky. Recent research from neuroscience has demonstrated that our brain has an altruism center which is separate and quite distinct from the center aroused by financial incentives. Financial incentives trigger one of the most primitive parts of the brain, namely the nucleus accumbens, which has traditionally been associated with our "wild side." Scientists call this region the "pleasure center" because it is linked with the "high" that results from drugs, sex, and gambling. Furthermore, research shows that the pleasure center and the altruism center cannot both function at the same time: Either one or the other is in control. Finally, it turns out that when the pleasure and altruism centers go head to head, the pleasure center seems to have the ability to hijack the altruism center. In other words, there is a neurophysiological reason why exaggerated financial incentives can override our altruistic motives. For this reason, companies should make sure that financial incentives are not exaggerated and are in any case properly aligned with the desirable objectives of building lasting greatness.

Making great people decisions

Be sure to make great people decisions, hiring or promoting the best. It is extremely important to recognize that the difference between a typical performer and a top performer is huge and grows exponentially with the complexity of the job. In addition, when Jim Collins, one of the most prominent contemporary business thinkers, was asked how important executive compensation and incentive decisions are for building a great company, he concluded, after 112 analyses, that his research could find no pattern. In other words, executive compensation appears to play no significant role in determining which companies become great. These two points – the spread of performance and the lack of a clear link between executive compensation and corporate results – strongly reinforce the argument that, much more important than how much to pay or even how to pay, is to decide whom to pay in the first place.

Respecting an innate sense of fairness

Pay reasonably well. The research by Jim Collins shows that "good-to-great" companies pay reasonably well in order to attract and retain the right people in the first place. However, the purpose of compensation in his view is not to "motivate" the right behaviors from the wrong people. Compensation should be reasonable because it is part of human nature to expect fair treatment when it comes to compensation, which should be somehow proportional to our efforts and/or results. This sense of a fair deal seems to be genetically anchored. Other primates also respond with aggression or anger when they feel unfairly treated. This has been revealed by some fascinating research with capuchin monkeys. In their experiments the primatologists created a market in which monkeys were trained to give them a pebble in exchange for food. While 95% of the monkeys participated in that market initially, when relative rewards became unfair only 20% of the monkeys continued to trade… and some got so frustrated they simply tossed away their pebbles!

Consider value added, rather than profitability. In difficult times, when profitability is reduced (or even negative) it is only natural to consider paying less. This, however, is not necessarily the right approach. A few years ago we met with the chairman of a financial institution in a Latin American country. Due to a major local crisis, the company had incurred one of its largest historical losses, amounting to several billion dollars. The board's response, however, was to implement an incentive program for a few key executives – and the packages at stake were quite significant. When we asked why they were doing so at such an unlikely point in time, the chairman told us: "These key people will enable me to cut my losses at least by one billion dollars. Cutting losses by one billion dollars is equivalent to increasing profits by one billion dollars. In our position, wouldn't you make sure to retain and properly reward the individuals who will allow you to create that much value?"

The best way to attract, retain, and motivate the best is through attractive jobs and careers, and good bosses. In today's knowledge-world, performance is increasingly the result of one's motivation to do a good job, which can only happen as a result of the passion to share a mission while focusing on building lasting greatness. When it comes to rewards, money talks, but passion sings.

Designing equitable reward systems

So in the future, when designing effective management reward systems HR departments and above all governing bodies will do well to keep a few principles in mind:

Think long-term. One of the reasons why privately held companies are in some cases doing better than publicly quoted ones is, of course, their emphasis on the long term. The higher the level of an executive, the larger the proportion of the package that should be associated with the long term. From this point of view, restricted shares should be preferred over stock options, and if stock options are included, they should have long vesting periods and be properly performance-related to the market, relevant indices, or appropriate goals.

Ensure commitment. The abusive practice of huge parachutes is obviously not the right way to ensure commitment, and in some cases has even acted as an incentive to end the relationship.

Don't forget the short term, but treat it differently. While very substantial components of an executive's compensation should be tied to the long term, the short term should still be relevant. However, while long-term compensation should be mostly associated with the increase in the value of the company, adjusted by relevant market and sector indicators, short-term incentives should be related to the key drivers of a business, such as employee engagement, customer satisfaction, or whatever the key indicators for your profit chain may be.

Promote collaboration. In our knowledge-based economy, an overwhelming body of research is demonstrating that firms with collective incentives share much more knowledge, and are indeed far more profitable than those that reward individual performance.

And last but not least, decision-makers should ask themselves: Is it fair? Coming back to the CEO conference with which we began: At one critical point in the debate, a leading world authority in the field of corporate governance made the point that a significant proportion of scandalous compensation packages had, in his view, been associated with hiring abuses. When a board is at the critical stage of closing a key appointment deal, and particularly a critical external hire, before the decision-makers give in and sign on the dotted line, they should think hard about whether the deal is really fair. How would they feel if the details became public knowledge? While it may be difficult to accurately and rationally define what is a fair deal, that deep-rooted innate human sense of fairness can be helpful. Or to borrow a phrase from Potter Stewart, the legendary Associate Justice of the U.S. Supreme Court, when asked to define hardcore pornography: "I know it when I see it!"

THE AUTHORS

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