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Making executive pay work
The psychology of incentives

A global study into the impact of pay and incentives on senior executives.

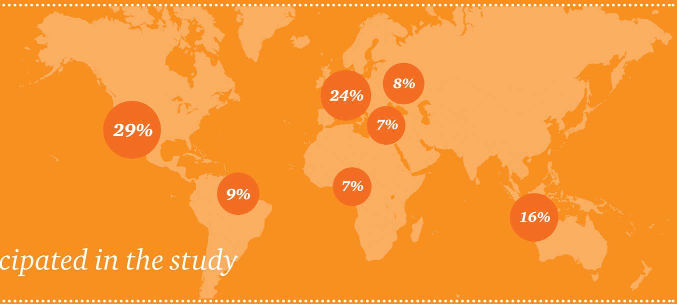
About our study

This research was carried out by PwC[1] in conjunction with the London School of Economics and Political Science. 1,106 participants took part in the study, 81% of whom were male and 19% female. 187 worked in the financial sector (22% of whom were female).

The executives had a wide range of senior roles in various sectors and were categorised into three earnings' bands of $350,000 and under (66% of participants), between $350,000 and $725,000 (24% of participants), and over $725,000 (10% of participants).

Participants

1,106



1,106 executives from 43 countries participated in the study

81% *Male*

Female **19%**

66%

Earned $350,000 or under

24%

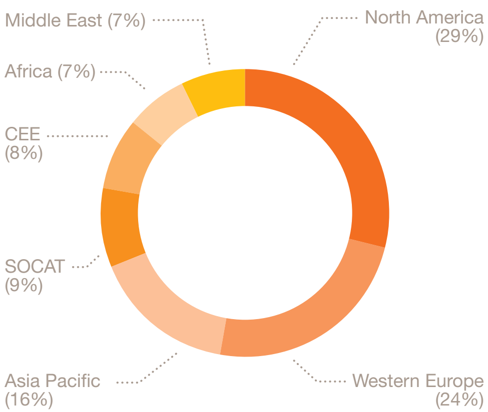
Earned $350,000–$725,000

10%

Earned $725,000 or more

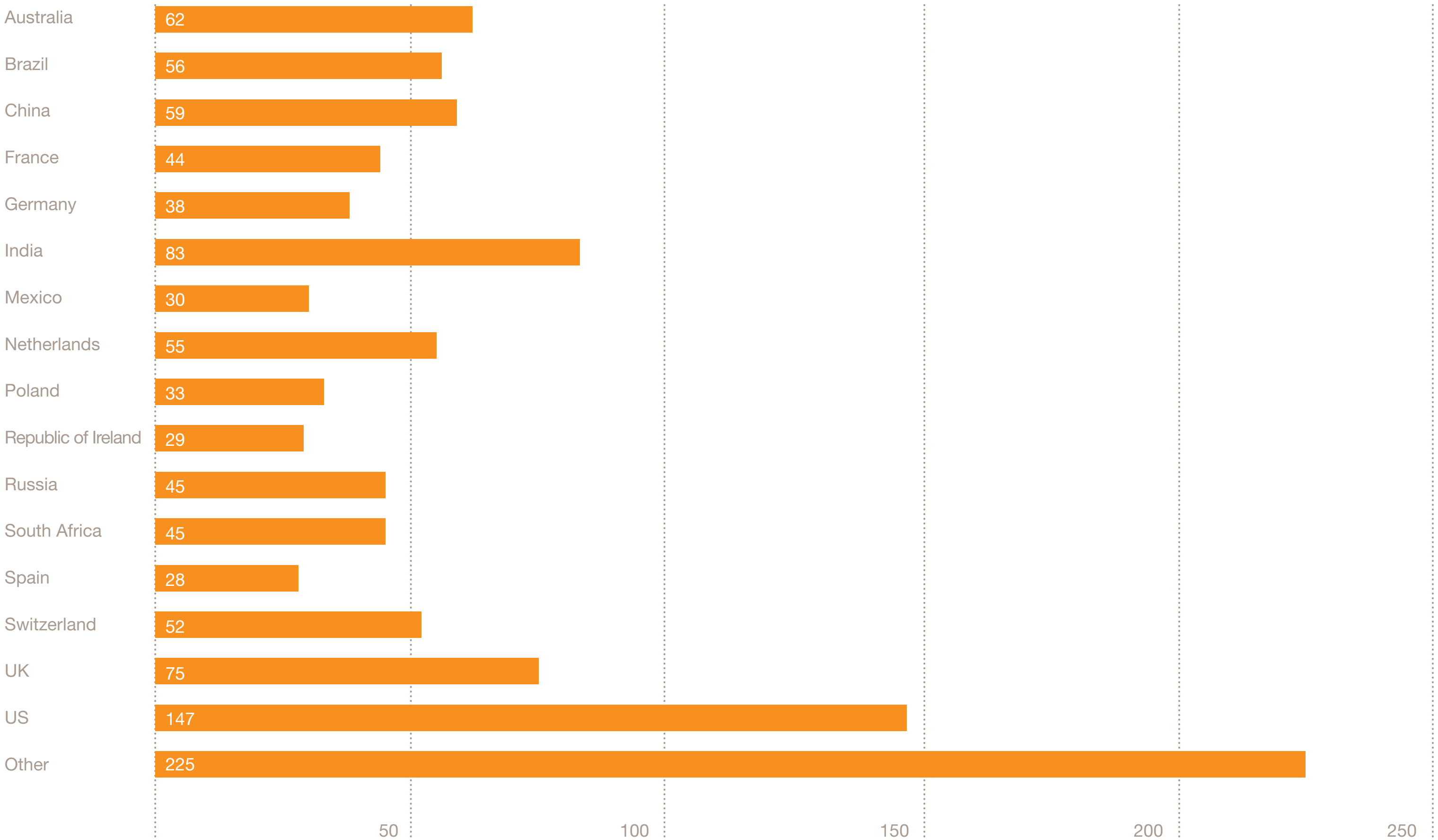
[1] "PwC" refers to the network of member firms of PricewaterhouseCoopers International Limited (PwCIL), or, as the context requires, individual member firms of the PwC network.

Participants by region



Q10: Where are you based?
Base: All respondents (1,106)

Participants by country



Q10: Where are you based? **Base:** All respondents (1,106)

'The results illustrate much of what's wrong with executive pay – and there is plenty wrong – but also what works.'

Executive pay isn't working

There is an emerging consensus, at least in Western economies, that there is something deeply flawed about the current model of executive pay. Put at its simplest, executive pay has risen dramatically over a period when, in hindsight, the Western economic model has not been at its most successful. Surely something must be wrong?

The debate about executive pay has focused on whether shareholders are getting what they want, whether current levels of executive pay are acceptable to society and whether remuneration committees are doing their job properly. But surprisingly little attention has been paid to perhaps the most important constituency: executives themselves. If executive pay were genuinely motivating executives towards higher levels of performance, with benefits for all, there would surely be less controversy about the subject. But is it? Does the current model really work for the individuals it is meant to be motivating?

Last year, in conjunction with Dr Alexander Pepper of the London School of Economics and Political Science, PwC carried out an initial study in the UK which was designed to test how company executives value and react to different types of pay. The study was driven by a belief that the fundamental model of executive pay in the UK was flawed and that in order to fix the problem, we had to go back to the basics of human behaviour. The resulting report was a revealing indictment of many of the features of the current executive pay model. In particular, it provided insight into why long-term incentives often just don't work.

The next step for us was to discover if the same results hold true for executives globally and this report explains the findings of a comprehensive study of executives across 43 countries. The results illustrate much of what's wrong with executive pay – and there is plenty wrong – but also what works. Some of the regional and country differences in attitudes hold valuable insights for leaders of multinational organisations. We hope it will prove an important contribution to the debate over executive pay.

“A clear and immediate reward for successes motivates people. Promises that extend way into the future demotivate people.”

Male Executive, Pharmaceuticals, USA

Executive summary

Key findings

Executives are risk-averse

Most people chose fixed pay over bonus of a higher value – only 28% chose the higher risk bonus

Executives in Australia and the UK are most risk-averse, those in Brazil and China most willing to take on risk in their pay

Complexity and ambiguity destroy value

Fifty percent more executives choose a clearer pay package than a more ambiguous one of the same or potentially higher value

Two-thirds more executives prefer an internal measure they can control (such as profit) as opposed to an external relative measure (such as total shareholder return)

The longer you have to wait the less it's worth

Executives value deferred pay significantly below its economic or accounting value – a deferred bonus is typically discounted by around 50% over three years

Discounts are particularly high in Asia and Latin America, with deferred payments being discounted by up to two-thirds in the eyes of executives

It's all relative – fairness is fundamental

Most executives would choose to be paid less in absolute terms but more than their peers – only a quarter choose a higher absolute amount, but which is less than their peers

Fairness is much less important in Brazil and China than in other territories, but you can't generalise about BRICs, as it is most important in India

People don't just work for money

Participants would take a 28% pay cut for their ideal job

The result is very consistent, globally, with the lowest cut being 24% (India) and the highest 35% (USA)

The key motivation of a long-term incentive plan is recognition

Fewer than half of executives think that their long-term incentive plan is an effective incentive

But two-thirds of participants value the opportunity to participate in their firm's long-term incentive plan

Design recommendations

Performance pay has a cost – be sure you're getting value

Performance pay is discounted compared to fixed pay by around 10% for cash bonuses and 50% or more for deferred bonuses and long-term incentives

Be sure the inefficiency of paying your people through performance pay is outweighed by benefits such as the incentive to perform better or the cost flexibility provided

Keep it short, sweet and simple

Be thoughtful about where deferral and long-term incentives are operated, and restrict their use to where there is a clear payback

Whenever possible go for the simpler option – requiring executives to hold shares may be a better approach than plans with complex performance conditions

One size does not fit all – know your people and pay them accordingly

Be cautious about assuming your pay design will work globally – attitudes to incentive pay are very different in developed and emerging markets

Think about how to provide choice and flexibility in pay programmes – higher perceived value may outweigh the administrative cost

Money is only part of the deal – and recognition matters as much as financial incentives

Pay is as much about fairness and recognition as it is about incentives

Simpler plans can achieve the recognition benefit with less discount to perceived value

Be realistic about how variable pay can be from year to year

Only a limited number of executives will be motivated by highly leveraged and volatile pay packages – less volatility may mean you can pay less

If incentives form the majority of the total package, accept that they won't be zero very often

It’s all about incentives

‘Globally, there is an increasing trend for companies to turn towards incentive pay, for a variety of reasons.’

Incentive-based pay for executives and senior management has become almost ubiquitous over the past two decades. The transformation in developed economies has been largely driven by the desire to align the interests of management and shareholders on the assumption that executives will perform better if they are heavily incentivised. The financial crisis and subsequent recession in many developed countries added another dimension to the debate. The crisis has resulted in an intense scrutiny of executive pay, particularly in financial services. This reinforced companies’ natural tendency to seek to link pay and performance more closely – and that inevitably means through long-term, usually share-based, incentive schemes.

This is not a uniquely Western phenomenon. Globally, there is an increasing trend for companies to turn towards incentive pay, for a variety of reasons. Performance pay provides flexibility in uncertain times. Governance has gone global, and shareholders in many markets have become more active in pressing companies to link pay to performance. There’s an element of developing economies choosing to adopt Western compensation practices in order to compete with Western employers that have entered their market. And employment market forces have also played their part. The intense competition for talented executives in the fast-growing BRIC countries, for instance, has driven up reward packages and in those countries with high churn rates, long-term incentives are seen as a vital tool in retaining the best. The theme of the last decade has been global convergence – of pay levels and structures – for an internationally mobile group of senior executives.

The end result is that incentives and performance-based equity are the pay structures of choice. Long-term incentive (LTI) plans have become evermore complicated, often combined with clawback arrangements, net holding requirements and performance-based deferrals of cash bonuses in response to shareholder and regulatory pressures, and in an attempt to align pay to business performance.

'As the saying goes, the definition of insanity is doing the same thing over again and expecting a different result.'

But do they work?

The fundamental question, though, is whether incentives actually do the job they're intended to do.

Reward design tends to assume that people make rational decisions, but is that really the case? The issue of performance pay has polarised academics for some time, but questions are increasingly being asked about its effectiveness. In those markets that have used them longest it's also becoming increasingly clear that there is something seriously wrong with LTIs. Companies invest an enormous amount into these plans, but the response from executives can rarely be said to justify the cost.

The recent financial crisis and the perception that bonuses played a role in causing it has led to a renewed focus on performance pay. But even now, the 'solutions' put forward are still based on the assumption that performance-related pay works, and that the answer is to structure it differently, to have more sophisticated payout formulae and to defer pay over longer periods.

As the saying goes, the definition of insanity is doing the same thing over again and expecting a different result. Given that this 'age of governance' has not coincided with a period of conspicuous success for the Western economies that gave birth to it, it's surely valid to ask some challenging questions about pay for performance, and in particular, LTIs.

'It's surely valid to ask some challenging questions about pay for performance, and in particular, LTIs.'

What do executives really think?

'Are BRICs different from developed economies? Are men different from women? Do executives from different sectors vary in their attitudes?'

Our latest research, in conjunction with Dr Alexander Pepper at the London School of Economics and Political Science, seeks to provide the evidence that's needed about how executives – the group of people whose performance is meant to be improved by incentive pay – react to incentives.

This research follows on from a joint study of around 100 UK executives, which led to our 2011 research report and which led us to question the effectiveness of LTIs and to set out a series of design principles that companies should follow to get the best value for money.

We wanted to find out if the results held globally for all executives. Are BRICs different from developed economies? Are men different from women? Do executives from different sectors vary in their attitudes?

So we worked with Dr Pepper to extend the study. The research involved asking senior executives to complete a structured interview questionnaire, based on well-established techniques of behavioural economics, which explored the trade-offs that individuals make between risk, reward, certainty and time. Our panel of participants comprised 1,106 executives in 43 countries, within a wide range of senior roles, companies and industries.

For the first time, we analysed the responses of our participants by gender, by age and by country. We also examined whether executives in the financial services sector – who are more familiar with the financial technicalities of incentivised pay – react any differently than executives in other sectors. The results reveal a number of common behavioural traits, which show clearly that executives don't necessarily think in the way that many incentive schemes assume.

So what did we find? Broadly, the research supports the findings of the UK study, although there are some fascinating variations by geography and gender. Our report shows that there are many features of deferred pay and LTI plans that are likely to limit their effectiveness. But there is also evidence that we shouldn't throw the baby out with the bathwater; nearly half of the participants said that their company's LTI plan was an effective incentive, and two-thirds said they valued the opportunity to participate in it.

To get best value from these plans, it's important to base designs on evidence rather than conjecture, and to use our latest understanding of behavioural science to come up with performance plans that actually do what they are meant to do. Performance pay is with us – we need to make it work.

Executives are risk-averse

"It's a given that employees will act to maximise anticipated reward. I will always choose more over less, now over later, and certainty over uncertainty."

Male executive, Malaysia

Executives' attitude to risk was assessed with two questions which asked participants to choose between a smaller, certain amount of money and a 50% chance of receiving a larger sum with a higher expected value (the amounts were adjusted to take account of the executives' current pay). The first question was framed as a gamble, the second as a bonus opportunity:

Attitude to risk

Which would you prefer as a one-off gamble?

a. 50% chance of $5,250 (or nothing)
b. $2,250 for certain
c. Indifferent to a) or b)

Given that the annual bonus of a senior executive of a large company is around $45,000, which would you prefer?

a. 50% chance of receiving a bonus of $90,000 (or nothing)
b. $41,250 for certain
c. Indifferent to a) or b)

It's clear from the results that risk aversion increases with the amount at stake, and that people will tend to choose more certain but less generous amounts over less certain but more generous outcomes. When offered a smaller certain amount or a gamble for a larger sum, just over half of all respondents (51%) chose the certain amount. This seems to be a universal preference; contrary to popular perception, executives working in the financial sector were slightly more risk-averse than the general population.

Participants in Africa were the most risk-averse, with 61% choosing the certain sum. This increased to nearly two-thirds (64%) when the amount was increased. There was only one region – South America – where more participants chose the gamble over the certain amount, and even in this case their preference switched when a larger amount was offered as a bonus opportunity rather than a salary. In all other cases, the majority preferred the smaller, safer option, or were indifferent between the two choices.

But while it's true to say that the majority of executives are risk-averse, a closer look at the results give the clear message that one size doesn't fit all. Overall, more than a quarter (28%) of participants were prepared to gamble a certain sum for a potentially higher bonus. In other words, a sizeable proportion of executives are active risk seekers.

Prepared to take a gamble?

Population	Proportion prepared to swap a certain sum of $41,250 for a variable bonus of up to $90,000
Overall	28%
Women	23%
Men	30%
UK and Australia	15%
Netherlands, Brazil, China	35%+
Financial services	32%

The research confirms the widely held view that women are more risk-averse than men. But there were also some surprises. Executives over the age of 60 were the most likely to take a gamble, while those aged 40–60 were least likely to risk the smaller, certain amount for the chance of a bigger win. Perhaps this is because older executives are more financially secure and have fewer commitments. Few would be surprised that executives in the developed economies of the UK and Australia are more risk-averse than in the rapidly growing Brazil and China – but the Dutch appear to like a gamble too.

This reinforces the point that companies need to know their audience. Incentives are more likely to work for risk-takers, but not everyone likes risk to the same degree. Our study shows that most employees demand a premium of over 10% to take pay in bonus rather than salary, meaning that bonus is a relatively expensive way of paying many executives. Companies need to be sure that what they get in terms of improved performance and increased flexibility of cost is worth what they're paying.

One size doesn't fit all

40–60

Those aged 40–60 were least likely to risk the smaller, certain amount for the chance of a bigger win

When offered a smaller, certain amount or a gamble for a larger sum, just over half of all respondents (51%) chose the certain amount

60+

Executives over the age of 60 were the most likely to take a gamble

Only around a quarter (28%) of participants were prepared to gamble a certain sum for a potentially higher bonus.

Complexity and ambiguity destroy value

> *"I don't assign any value to my share allocations. I consider them in the same way as a company lottery ticket."*
>
> Female executive, Australia

The study tested attitudes to uncertainty with three questions. The first was framed as a straightforward gamble – a choice between a 50% chance of winning a certain amount, or a chance of winning the same amount where the probability was unknown but could be anything between 25% and 75%. The second and third questions were framed as share and bonus awards:

Impact of complexity

You are invited to participate in a one-off gamble. Which of the following choices would you prefer?

a. 50% chance of winning $5,250 (or nothing)
b. A chance P% of winning $5,250 where P is unknown but is expected to be somewhere between 25% and 75%
c. Indifferent between a) and b)

Given that the annual bonus of a senior executive in a large company is around $45,000 and the median long-term incentive award is around $67,500 a year, which would you prefer?

a. A guaranteed bonus of $45,000 payable in three years' time
b. A guaranteed bonus of 20,000 shares deliverable in three years' time. The current share price is $2.25 and in the past 12 months the share price has fluctuated between $1.12 and $3.37
c. Indifferent between a) and b)

Given the same facts, which would you prefer?

a. A cash bonus of up to $52,500, which will be paid in three years' time if the company's earnings per share grow at at least 3% more than the Retail Price Index
b. A bonus of up to 23,350 shares, deliverable in three years' time, depending on the company's relative total shareholder return over the period when compared against a basket of comparable companies
c. Indifferent between a) and b)

Executives clearly wanted to understand the rules of the game. Fifty percent more executives wanted to know the probability of the gamble they were taking than were prepared to bet on a situation where the probability could be higher or lower. And overall, two-thirds more favoured a cash plan based on a condition that was internal to their organisation (earnings per share) over the more ambiguous share plan based on relative total shareholder return.

Dislike of relative total shareholder return was most pronounced in those countries that have lived with it the longest and so suffered its vagaries more than others, namely the UK, Netherlands, Switzerland and Australia, although the Chinese and Indians were also less than keen.

Attitudes to deferred shares versus deferred cash were quite varied. Overall, there was a slight preference for deferred cash, with around a fifth more executives preferring cash over shares, although there were some significant differences by country.

Cash or shares?

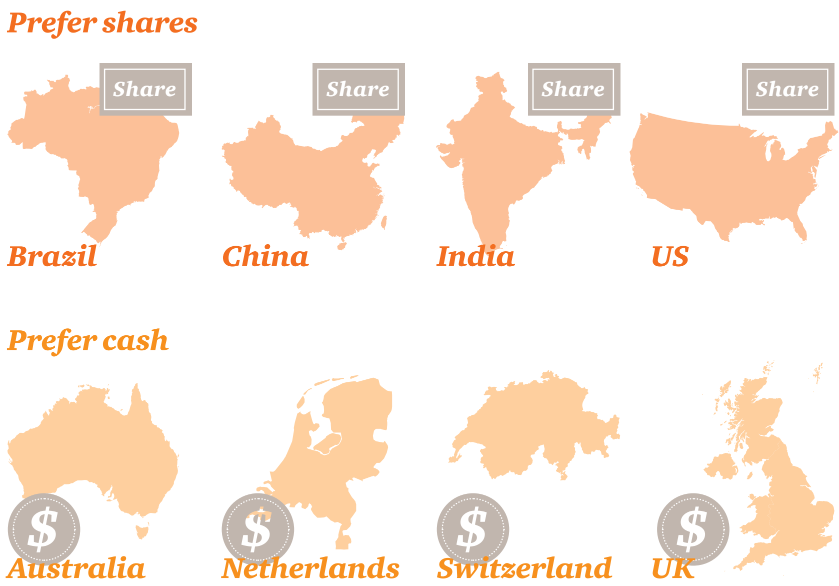
Prefer shares	Brazil, China, India, US
Prefer cash	Australia, Netherlands, Switzerland, UK

It's interesting that executives in the BRIC nations – where it's often assumed a 'here and now' culture pervades – tended to prefer shares over cash. Of course, both the cash and the shares are deferred, so if they have to be locked into the deferral, perhaps they are inherently more optimistic about the upside that shares provide.

Once again the over-60s belied the image of conservative sexagenarians – they were far more willing to take on uncertainty in exchange for a higher upside. Only 29% of those aged between 60 and 64, and 32% of those over 65, chose the smaller cash bonus over shares.

The message here is that uncertainty and complexity are a turn-off for most people. In almost every case, participants selected the less complicated option. The more complicated the reward, the more likely they were to choose the smaller but more certain award. Given that most LTI plans are invariably complicated, there is a clear warning here that an unnecessarily complicated system is unlikely to produce the best results. But remember that complexity is relative – if executives deal with the metrics and reporting information that are linked to their awards as a regular part of their job, it will appear simpler to them than it would to someone who only comes across these measures when it comes to assessing their performance.

Cash or shares?



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> *"People need to feel that their efforts are being rewarded in a concrete way."*
>
> Female executive, Poland

The longer you have to wait, the less it's worth

Executives' attitude to time was assessed using three questions that compared the possibility of receiving a certain amount today, or a larger sum in three years' time. Some of the questions were framed in such a way that it was possible to estimate the discount rates that participants attach to the deferred payments.

Impact of time on perceived value

You're invited to take part in a one-off gamble. Which of the following choices would you prefer?

a. 75% chance of winning $2,250 tomorrow (25% chance of nothing)
b. 75% chance of winning $5,250 in three years (25% chance of nothing)
c. Indifferent to a) and(b)

Given that the median long-term incentive award of a senior executive of a large company is around $67,500 a year, which of the following choices would you prefer?

a. 75% chance of receiving a bonus of $37,500 tomorrow (25% chance of nothing)
b. 75% chance of receiving a bonus of $90,000 in three years (25% chance of nothing)
c. Indifferent between a) and b)

Given the same facts as above, which would you prefer?

a. 75% chance of receiving a bonus of $56,250 tomorrow, otherwise nothing
b. 75% chance of receiving a bonus of $90,000 in three years, otherwise nothing
c. Indifferent between a) and b)

The results show that when there is uncertainty about whether a payment will be received, executives across the globe apply discount rates to deferred payments that are massively in excess of economic discount rates. This is an illustration of the difference between financial theory and real-life behavioural economics. Financial theory says that individuals should discount at rates consistent with the return on comparably risky cash flows, which in this case should be near the 'risk-free' interest rate of around 5% per annum (used in accounting valuations of LTIPs). The study, though, shows that executives more typically discount at around 30% per annum – this is the economics of 'eat, drink and be merry, for tomorrow we may die'.

	All	Western Europe	North America	Asia-Pacific	Central & Eastern Europe	South & Central America	Middle East	Africa
Estimated discount rate	31%	20%	31%	42%	26%	45%	37%	40%
Perceived value of $1 deferred pro rata over three years	$0.50	$0.65	$0.50	$0.37	$0.56	$0.34	$0.43	$0.39

*For example, with a discount factor of 31% pa a three-year phased deferral of $1 will have a perceived value of: $\$1 \times (1/3) \times [(1-0.31) + (1-0.31)^2 + (1-0.31)^3] = \$0.50$

Younger executives tended to discount at a higher rate than others (those under the age of 39 applied a 45% discount rate). They have more immediate financial needs and are more likely to value money today over money tomorrow; those between the ages of 55 and 59 applied a rate of 22%.

The discount rates applied also varied from country to country. The table above shows the implied annual discount rate applied to deferred awards. The second row shows the resulting perceived value of $1 of bonus, which is paid out over one, two and three years, the typical deferral structure endorsed by financial services regulators.

This tendency to discount future awards heavily is replicated across all sectors. It might be safe to assume that anyone working in the financial sector would be used to deferral and might be more likely to discount at a reasonable rate, given that they have a better understanding of discounting than most, but this isn't the case. The discount rates that participants mentally apply to an amount received in three years' time are consistent for those working in financial services and those working in other sectors.

Shareholders, regulators and corporate governance bodies have generally assumed that deferred bonuses are a powerful way of influencing behaviour and aligning executives with shareholders and prudent risk-taking. These findings place a significant question mark over the effectiveness of the deferral model. The best-case scenario, in Europe, is that deferral results in a discount of one-third in perceived value. But in emerging markets and the BRICs the discount is more like two-thirds. This seems to be a very heavy price to pay. A clear consequence is that as deferral increases, we should expect upward pressure on the level of compensation.

The data also shows the dangers of pushing a one-size-fits-all remuneration policy globally. Western companies expanding into emerging markets need to be very careful about assuming that home-country deferral policies will travel well.

Typical discounting

Executives typically discount at around 30% per annum – this is the economics of 'eat, drink and be merry, for tomorrow we may die'.

It's all relative – fairness is fundamental

> *"It really becomes a problem when people start to talk. If you don't know what people earn, it's not a problem."*
>
> Male executive, UK

One of the strongest messages to come out of the research was that the overriding concern for executives is whether their pay is comparable against their peer group. The results suggest strongly that executives are content as long as they are paid what they consider to be 'fair' within the hierarchy of their own company, and comparably against those on a similar level in competitor companies, to the extent that it almost becomes irrelevant how much they are paid. It seems to be deeply ingrained within human psychology to compare ourselves with others.

The executives were asked this question:

Testing attitudes to fairness through the relativity question

Jean and Jacques are two friends leaving business school. Jean is offered a job to join the senior management of Company A with a total reward package of $187,500. Jacques is offered a job on the senior management of Company B with a total reward package of $195,000.

Jean subsequently discovers that the average pay among A's senior management team is $180,000, while Jacques discovers that the average pay among B's senior management team is $202,500. Who's likely to be more highly motivated?

Participants almost everywhere agreed that Jean was better motivated than Jacques. In other words, getting paid more than their peers was more important than getting paid more in absolute terms. But there were exceptions. Only 35% of executives in Central and Eastern Europe said that Jean was better motivated, while 45% favoured Jacques. Similarly, in China and Brazil, the higher absolute sum was felt to be more motivating. Fifty-six percent of Chinese said that Jacques would be more motivated. Could it be that executives in countries that are experiencing higher levels of economic growth are more interested in absolute wealth creation, and so concentrate more on absolute amounts than relativity?

Another take on fairness was tested through the 'ultimatum game'.

Testing attitudes to fairness through the ultimatum game

Adam and Zoe are brought together in an experiment:

- *Adam is given $100,000 and told he can split this in any way he likes with Zoe.*
- *Zoe can then choose to accept or reject Adam's offer.*
- *If Zoe accepts the offer they both get their money.*
- *If Zoe rejects the offer they both get nothing.*

Adam and Zoe both know that the total amount is $100,000 and they both know the rules of the game. They can't negotiate because they are kept separate the whole time.

Participants were asked how much they would offer if they were Adam, and how much they would accept if they were Zoe. The economist's answer is that Zoe should accept whatever she is offered, as even $1 is better than nothing. Equally, Adam should only offer $1 and keep the rest. However, this goes against our instinct of fairness (not a known characteristic of economic man). An offer of $1 is too derisory to accept, and maybe Adam would be wiser to offer half the money, so he could be sure that he would at least get $50,000. But this ignores the fact that Adam has been given the right to determine the offer.

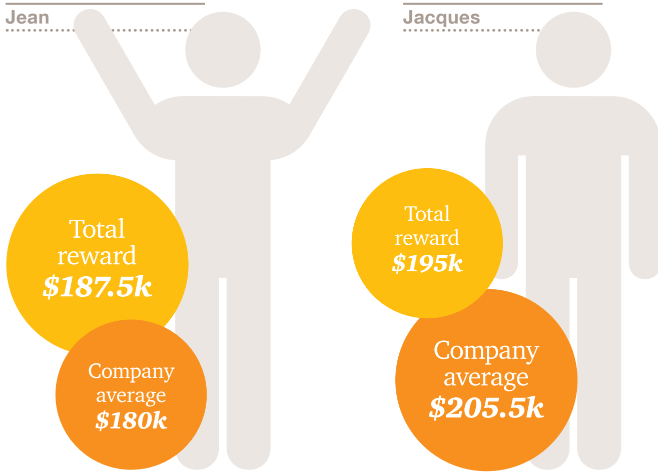
Half of respondents set the maximum amount they'd offer equal to the minimum amount they'd accept – reflecting a strong sense of fairness. One-third were more cautious – they'd accept less than they'd offer. In other words, they would play it safe to make sure they got some reward. Only 15% would play aggressively, offering less than they'd accept.

There was no major difference in the attitude of men and women, or between those working in financial services and other sectors. However, there were some interesting country differences. China was the only country where more people would play 'aggressively' rather than 'fairly', consistent with their approach to the relativity question. But those wishing to generalise across the BRICs should take care – India was among the countries with the highest proportion advocating a fair approach.

But why does this matter for the design and governance of pay? It's important for two reasons. The first is disclosure – in many countries there is a drive for greater disclosure of pay on the basis that this will lead companies to exercise restraint. This research suggests the opposite, that disclosure will simply provide more opportunities for cross-comparisons and consequent pay ratcheting.

The second point is that complicated incentive plans can sometimes result in an outcome that participants consider to be unfair, and unfairness is something that they remember, and resent.

Jean and Jacques



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There's more to work than money

"Personal fulfilment is very important. Money is a means to achieving what you want or need, but never should be the ultimate goal."

Female executive, Brazil

Money is only part of the equation. People work for pay and benefits (the extrinsic rewards), but also because they want to, and find it fulfilling (the intrinsic rewards). A pair of questions were asked to test this theory, and were designed to identify how much money people would be prepared to give up for their ideal job.

Ideal job discount

The first question asked participants to estimate the minimum salary that 'Franco', a senior executive at a large listed company, would be prepared to accept in his dream job, a senior management role at a music college. The second asked participants the maximum discount they would be prepared to accept on their own current pay, if they were offered their dream job.

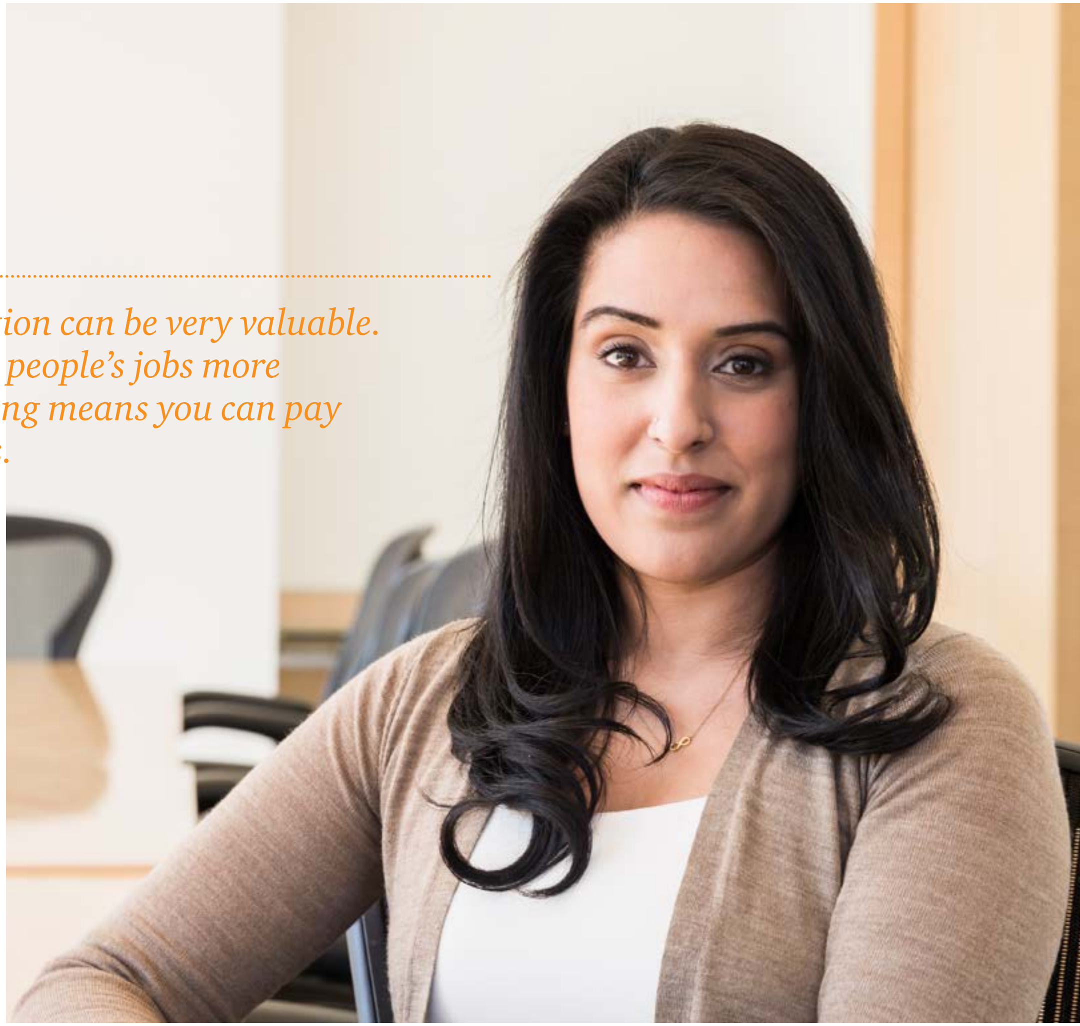
Participants were consistently more idealistic on Franco's behalf than when thinking about their own position. On average, they estimated that Franco should take a pay cut of 60% for his ideal job, but would only be prepared to take a 28% cut for their own dream job. The region accepting the lowest discount was Africa, with 24%. Indians showed the biggest gap between fantasy and reality – they said that Franco would accept a 70% pay cut, but would only accept 24% themselves. The US was where executives were most willing to give up pay for fulfilment – 35% was the median pay cut they would accept, although a quarter said they would do their ideal job for half the current pay.

The research has two interesting consequences. One is that increased job satisfaction can be very valuable. Investment in making people's jobs more interesting and fulfilling means you can pay them significantly less.

But the second consequence is that people clearly get anchored onto a current level of earnings. The discount people would accept for their ideal job was remarkably consistent across a wide range of roles, earnings' levels, geographies and industries. On the whole, people find it difficult to imagine working for less than about two-thirds of their current earnings. Those in the investment banking industry will understand this very well; pay has fallen by around a third over the last two years and employees are finding it difficult to adjust. They may still be very highly paid, relative to other industries, but they've been asked to accept the level of pay cut that most would only accept for their ideal job. Can banks really say that this is what they're offering? This may be a worrying omen for the future.

In a similar vein the results show that companies (and investors and regulators) need to be realistic about how variable pay can truly be, year-on-year. If a decrease of more than 25% represents a fracturing of the psychological contract in an executive's mind, then it may be that thinking that two-thirds of the package can be truly variable is little more than fantasy.

Increased job satisfaction can be very valuable. Investment in making people's jobs more interesting and fulfilling means you can pay them significantly less.



LTIPs motivate through recognition as much as incentive

The findings so far paint a grim picture for long-term incentives. Many of their key characteristics – high risk, complex and ambiguous performance conditions, arbitrary and unfair outcomes, multi-year deferral – suggest that individuals will discount them to a fraction of their economic value. And our experience suggests this to be the case.

Yet, intriguingly, the participants in our study had a more positive view. At the end of the survey they were asked three direct questions about long-term incentives:

LTI effectiveness

1. *Are you strongly motivated to participate in your firm's LTIP?*
2. *Do you value the opportunity to participate in your firm's LTIP?*
3. *Is your firm's LTIP an effective incentive?*

Overall, nearly two-thirds of participants agreed that they valued the opportunity to participate in their organisation's LTIP. Fewer than 20% disagreed. By contrast, fewer than 50% felt their firm's LTIP was an effective incentive and almost a quarter positively felt it was not.

So, it appears that to some degree, LTIPs are successful as a recognition tool (because those participating are seen to have a higher status) rather than as a meaningful direct incentive. Men were significantly more positive towards LTIPs than women, perhaps reflecting the greater importance they attach to status.

The results show that the countries where LTIPs are viewed as a most effective incentive are those that haven't experienced them as part of the compensation mix for very long, and where they do exist, they're generally in a fairly simple form. Executives in countries where LTIPs have gradually become more complex as a result of governance rules and shareholder guidelines are more jaded about their effectiveness:

LTIP effectiveness by country

Country	Proportion of respondents agreeing that their firm's LTIP is an effective incentive
Overall	50%
China	65%
UK	60%
India	55%
Brazil	53%
US	48%
Switzerland	38%
Australia	38%
Netherlands	29%

The unexpected outcome is for the UK – our consulting experience is that UK levels of frustration with LTIPs is very high. So is this a sampling error, or are LTIPs secretly more loved in the UK than executives let on?

Overall, the findings aren't encouraging for the governance-driven complexities of the western LTIP model. When even on an optimistic basis only half of participants view the plans as an effective incentive, there's surely much room for improvement.

Motivation through LTIPs

By contrast, only half felt that their LTIP was an effective incentive.

What does it mean for reward?

This research suggests that many aspects of long-term incentive plans mean they are designed to fail. Executives are risk-averse, don't like complexity and discount deferred pay. The pay systems we've adopted have many features executives dislike and don't value – and we've had to pay executives more to compensate. If pay better reflected executive psychology, maybe it could be lower.

Of course the key findings hide a wide degree of variation. For example, although on average executives are risk-averse, more than a quarter are risk-seeking, rising to nearly half in China. Time discounting is particularly severe in Asia-Pacific and in Central and South America, with deferral wiping around two-thirds off the perceived value of a bonus as opposed to one-third in Western Europe. Even generalising about emerging markets is a mistake – for example Indians are far more concerned about fairness than the Chinese. While the findings hold true in general, companies need to be aware of the exceptions.

What recommendations can we draw for business leaders?

Performance pay has a cost – be sure you're getting value

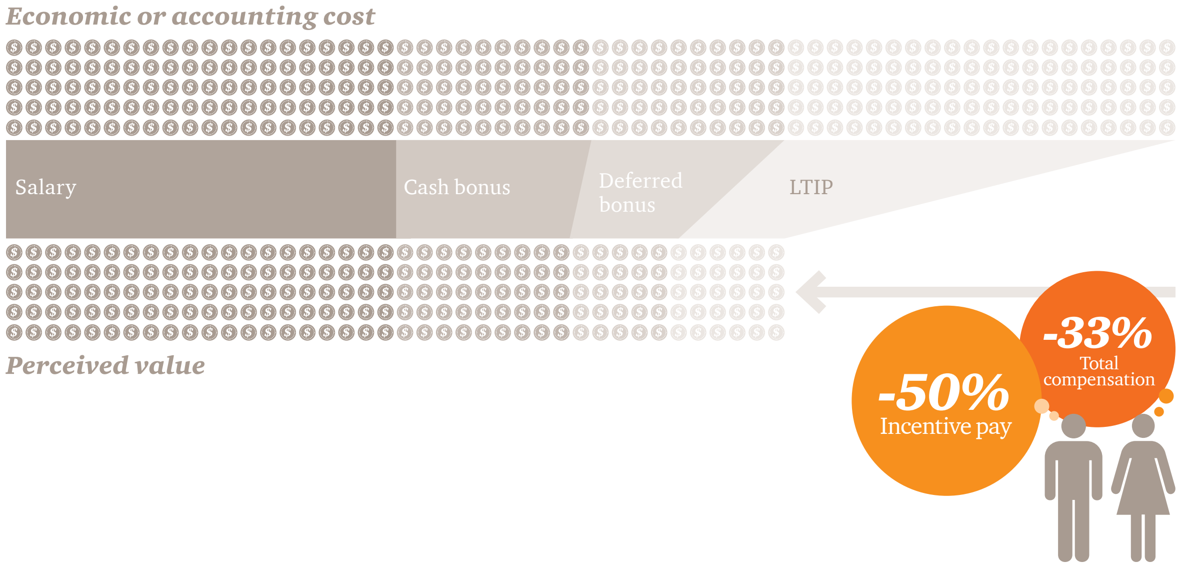
Our research shows that executives materially discount bonus relative to fixed pay, deferred pay relative to immediate pay, and complex or ambiguous schemes relative to simple ones. Add it all up and incentive pay can easily be discounted by half, relative to fixed pay in executives' minds.

So paying in incentives rather than salary is an investment. And like any investment companies need to be clear about the pay-back. Is the payback better performance? If so, what's the evidence you're getting it? Is it about cost flexibility? If so, how much do you need? Is it just that you've got to offer it because everyone else does? If so, have you tested that assumption?

In too many cases performance pay is deployed with blind faith rather than cold analysis. Companies should challenge themselves whether everyone who is in a performance pay plan should be, and if so then to what extent.

Of course, kicking the performance pay habit can be hard, because how do you manage without it? Well, maybe that's the answer – you manage.

Incentive pay can easily be discounted by half, relative to fixed pay in executives' minds



> *The pay systems we've adopted have many features executives dislike and don't value – and we've had to pay executives more to compensate.*

Keep it short, sweet and simple

If using performance pay has a cost, deferring it just multiplies that. Our research shows that on average, a simple phased three-year deferral (so beloved of financial regulators) will reduce the perceived value of pay by one-half on average. The impact in the BRICs is even more extreme with deferral wiping around two-thirds off the perceived value of pay.

The agency theory view is that deferral makes executives think longer term. But it is difficult to see how something that has such low perceived value can be a significant influence on behaviour. Deferral does, of course, enable bonuses to be reduced if performance declines, and there are cost advantages, as well as a sense of natural justice in this. But why not just pay less in the first place, but in a form executives value more?

This also helps with simplicity. Complex plans are a motivation killer. The idea that we can manage by incentives has led to evermore complex metrics frameworks and formulae. These have many consequences, most of them unintended. But a key one is the further reduction in value they cause in the eye of the executive.

Relevance is another important factor – adopting performance conditions that are perceived as relevant to executives' jobs and within their influence improves appreciation. Relative external metrics such as Total Shareholder Return, while good in theory, rarely motivate in practice. Using simpler plans based on long holding periods for stock may be a better way of aligning executives and shareholders than complex performance metrics.

Where performance pay is used, we need to adopt the simplest possible form. Regulatory constraints and shareholder guidelines make this challenging. Sometimes there will be no choice but to adopt more complex arrangements than is ideal. But where there is choice, let's take the simpler path.

One size does not fit all – know your people and pay them accordingly

Different demographic groups have a different attitude to risk, and cultural factors also have their part to play in different geographies. This suggests that a centralised incentive strategy simply won't work. Organisations should start developing a deep understanding of the attitudes and preferences of their own executive population.

'Clone and go' incentive strategies have become popular because of their administrative simplicity and internal comparability, but this study shows there's likely to be a significant cost incurred for standardisation. Organisations need to think about how to adopt tailored reward programmes, where employee choice plays a bigger role, without losing control.

At one level this may mean more tolerance of different regional or country practices. A hard-headed cost-benefit is needed. If more flexibility makes pay programmes more effective, then perhaps this is worth the extra administrative cost?

There's also a role for greater choice here. We've got used to the idea of flexible benefits as a way of increasing the perceived value and flexibility of benefits' packages. Why not extend further? Some companies already offer the choice between restricted stock and options for example, generally with results that suggest perceived value is improved. Could this concept be extended more widely through pay packages? Again, the trick will be to do this in a way that doesn't just mean spiralling complexity. But the potential gain is considerable.

Money is only part of the deal – and recognition matters as much as financial incentives

Most executives said that they were motivated by more than money. Investment in engagement and corporate culture can save a significant amount from the pay bill, through individuals' willingness to accept a pay discount for more fulfilment. Recruitment and retention decisions go beyond the purely financial.

Moreover, the recognition provided by participation in LTIPs seems to be more important to motivation than the financial incentive. Companies should think harder about how they communicate this rather than working on evermore technical LTIP designs.

But the strongest findings in this area relate to fairness. This comes across as critically important for many executives. Of course, fairness is easier to preach than to achieve, but must be an objective. This will require appropriate discretion in pay systems – and the information and management maturity to apply it – to ensure fair outcomes.

Be realistic about how variable pay can be from year to year

Even for their ideal job, executives will only accept a 28% pay cut – a finding that was remarkably consistent across the survey population. Yet, variable pay typically forms two-thirds of compensation for the most senior executives. Can it really be this variable? The evidence suggests not. This issue has caused much of the angst in the debate over executive pay. Maybe we need to acknowledge that we've tried to make incentives too big a part of the total. Simpler, less leveraged packages, with less volatile outcomes may be more valuable to executives and cheaper for shareholders.

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Most of all, the design of performance pay needs to be simpler and more relevant to the people whose behaviour it's meant to influence – executives themselves.

Looking to the future

We see that performance pay still has an important role to play. But its use needs to be more discriminating. In some situations you're better off without it – the business case for its use needs to be clear.

We need to consign to the scrap heap the agency model approach to executive pay, based on 'rational economic man', which has been so unhelpfully influential in current Western pay systems.

Most of all, the design of performance pay needs to be simpler and more relevant to the people whose behaviour it's meant to influence – executives themselves.

Contacts

United Kingdom
Tom Gosling
+44(0)20 7212 3973
tom.gosling@uk.pwc.com

USA
Scott Olsen
+1 646 471 0651
scott.olsen@us.pwc.com

Switzerland
Robert Kuipers
+ 41 (0)58 792 4530
robert.kuipers@ch.pwc.com

Germany
Barbara Seta
+49 69 9585 6044
barbara.seta@de.pwc.com

Netherlands
Janet Visbeen
+ 31 8879 26429
janet.visbeen@nl.pwc.com

India
Padmaja Alaganandan
+91 80 4079 4001
padmaja.alaganandan@in.pwc.com

South Africa
Gerald Seegers
+27 (11) 797 4560
gerald.seegers@za.pwc.com

Australia
Della Conroy
+61 3 8603 2999
della.conroy@au.pwc.com

Hong Kong
Bruce CH Lee
+(852) 2289 5510
bruce.ch.lee@hk.pwc.com

Brazil
Joao Lins
+ 55 11 3674 3941
joao.lins@br.pwc.com

www.pwc.com/people

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