Current executive compensation appears to be structured suboptimally in many ways. This is partly the outcome of the inefficient use of stock options, which are undervalued by both executives and the board; the over-reliance on extrinsic versus intrinsic motivation; and structural weaknesses in the compensation negotiation process. In empirical research and in the practical design of compensation, a more holistic approach is needed—one that takes into account the underlying assumptions of design, the prevalent institutional influences, and the psychology of human motivation.

Executive compensation has been studied extensively since the 1970s, theoretically based on the principal-agent theory and empirically based on extensive data provided by increasing disclosure requirements on CEO pay in the US. While there is, in principle, a well-functioning labour market for CEOs, there are also clear imperfections that cast doubt on the efficiency and effectiveness of the current compensation programmes. For example, a meta-analytical study by Tosi et al. (2000) found that size explained on average 40 per cent of variances in CEO compensation, while performance only related to 5 per cent.

It appears that the misalignment of corporate compensation structures is rooted in incorrect assumptions that underlie compensation schemes. These assumptions are products of the prevalent institutional influences and basic psychology of human motivation.
Are options plans inefficient?

One major reason for the misalignment of compensation is that options are more costly to both the issuer and employee than is often realised (see Murphy in Chapter 10). They are viewed by boards as a low-cost compensation mechanism, partly because of favourable accounting and tax treatment.

The second important issue is the cost borne by executives receiving these options as compensation. Managers are not marginal portfolio investors with widely diversified holdings. Instead, they are significantly overinvested in the firm through their human capital, current equity holdings and outstanding options. Therefore, options are of less value to the employee than their economic costs, with discounts ranging from 30 per cent to 50 per cent.

Executives perceive options – rightly – as risky, for which they seek compensation. Two forces influence this perception. Firstly, higher volatility of the underlying stock means higher risk to the individual overinvested executive (who, with human capital and much financial capital tied up in the fortunes of the firm, is far from the stereotypical widely diversified portfolio investor). Consequently, the executive seeks additional compensation for such risk. In addition, as a significant proportion of the compensation package is now based on the value of volatile stock, senior managers have a strong incentive to focus on managing income and to smooth the stock price, and with it their own inter-temporal income stream. This might influence management to be more cautious in their decision making, and might be in conflict with optimal risk taking from a firm’s perspective and with its shareholder value maximisation strategies.

Therefore, an optimal compensation package needs to take account of the personal characteristics of senior managers, including their financial situation, assets and liabilities, current equity holdings and stage of career. The board should consider the positions of individual executives when awarding options, and not a stereotypical average. It is also important to ask how far the share price has to rise to compensate for the extra assumption of risk for each individual assessed. Therefore, it is the differentiated structures of the compensation package that are most important in aligning principals and agents, rather than the aggregate size of a compensation reward. A recent survey of FTSE 350 senior executives confirmed