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Abstract

Performance pay, at least as usually understood, is no good idea for non-executive directors. They have to supervise and control or in some situations even to fire and replace the executive managers. This means that their performance as supervisors is totally different from the performance of the supervised executive managers and even the company at large. Moreover, they are mostly interested in other things than their pay. Thus, their pay should be fixed and not too high.

JEL-Codes: M12, M21, M52, G34, D23, D82, K22

Wie man Aufsichtsratsmitglieder besser (nicht) bezahlt

Zusammenfassung

Bezahlung nach Leistung, zumindest nach dem üblichen Verständnis, ist keine gute Idee für Aufsichtsratsmitglieder. Diese sollen die Vorstandsmitglieder beaufsichtigen und kontrollieren oder in manchen Fällen sogar entlassen und ersetzen. Das bedeutet, dass ihre Leistung als Aufseher eine vollkommen andere ist als diejenige der von ihnen beaufsichtigten Manager oder sogar des gesamten Unternehmens. Außerdem sind sie meistens mehr an anderen Dingen interessiert als an ihrer Bezahlung. Deshalb sollte ihre Bezahlung fix und nicht zu hoch sein.

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How (Not) to Pay Non-executive Directors

1. Introduction

There is a very extensive literature about performance pay for executive managers. At least before the current financial and economic crisis many economists thought that linking the pay of top managers and probably also lower ranking managers or even most employees to their performance is a good idea (see for example the vast literature on the principal agent literature starting with Ross, 1973, Stiglitz, 1974, Mirrlees, 1976, Harris/Raviv, 1979, Holmström, 1979, Shavell, 1979, and more applied Jensen and Meckling, 1976). Accordingly, the main problem is (or was thought to be) to define and measure performance properly and to find the right balance between strong incentives (Jensen and Murphy, 1990, complained that CEOs got only 0.3 % of the wealth created for shareholders) and risk-aversion. Since the start of the crisis (if not before like Bechuk and Fried, 2004, or Frey and Osterloh, 2005) one may ask whether the incentives for risk-taking have been too high or completely wrong, at least in banks.

Anyway, the literature about a special group of managers was and is much smaller and (even) less conclusive (see for example Gregg, Machin and Szymanski, 1993, Clarke, Conyon and Peck, 1998, Yermack, 2005, Bebchuk, Grinstein and Peyer, 2010, and especially for Germany Fallgatter, 2003, Raible and Vaupel, 2007). This group is formed by the non-executive directors (for an overview see Adams, Hermalin and Weisbach, 2010) or in a two-tier system like the German one (see de Plessis, 2004) by the members of the supervisory board (on both and their convergence see Hopt and Leyens, 2005). They have to supervise and control or in some situations even to fire and replace the executive managers. However, that means that their performance as supervisors is totally different from the performance of the supervised executive managers and even the company at large. In good times one may think that a high performance of the firm and the executives is also a sign of well performing supervisors although they often have nothing to do with or for that. In any case, in bad times good supervisors would lay open the mistakes of the executive managers and thereby depress the measured performance of the company in the short term. If they are paid by the success of the company, for example measured by its share price, they have the perverse incentive to cover any problems.

The next section starts with some general considerations about performance, especially of supervisors, and how to pay for it. Section 3 looks at different kinds of non-executive directors and shows that none is particularly motivated by pay. Section 4 concludes.

2. Performance, Pay and Supervision

2.1. Complete Knowledge

In a world with complete or at least symmetrical knowledge, where everyone knows everything or at least the same, it would be easy to value and reward the performance of executives and also non-executive directors. Everyone would know their performance and its value. However, because everyone knows the same, there is not any special value to managing and supervision in such a scenario. Being an executive would be a job like any other without justifying any extra pay (if executives and companies are needed at all in such a world without transaction costs, see Coase, 1937 and 1960) whereas non-executive directors would be totally useless. Only as far as they have or can generate any additional, (at least for a while) asymmetrical information they have a meaningful and valuable task. That means that analysing executive managers and non-executive directors cannot be done with the simplifying assumption of complete knowledge because their very existence depends on this assumption being not true. Executives know and do something others cannot do, at least not without being executives themselves. Perhaps executives have some innate talent or maybe they have not and their performance depends only on acquired human capital and the advantages of specialisation. Anyway, by doing their job they have some knowledge others do not have. Otherwise they would not be necessary. The same is true for non-executive directors.

2.2. Observable Performance of Executives

Although executive managers necessarily do have and use some special, private knowledge when leading a company, it is possible that the results of their activities are common knowledge and everybody can see their performance without being able to replicate it. For example, a perfect capital market would always determine the correct value of every company. The difference of this value with one particular CEO compared to the company's value with his or her next best replacement would be the additional value of this CEO. Depending on his or her bargaining power a CEO would get a larger or smaller share of this additional value besides the market wage. Anyway, measuring the performance of executives

could be done by the market without any need for supervising non-executive directors. Thus, companies could do without the later or should pay them as little as possible if they are prescribed by law.

2.3. Good Supervision

The interesting case it thus the realistic one of non-trivial measurement problems concerning the performance of executive managers. Non-executive directors exist to overcome or at least to reduce these problems. At the same time the measurement problem in regard of performance is repeated for them at a higher level. Because finding and supervising good executives is not trivial, the job of non-executive directors is important as well as difficult to evaluate by itself. The simple idea to outsource this task to the financial markets does not work for the executive managers and even less for their supervisors.

A high stock price could indicate good performance of executives and their supervisors but it could also result from problematic or even fraudulent activity, at least for a short while. Good executives would not behave this way but solve real problems instead of covering them. This is also true or even more so for good supervisors. However, that means that a drop in the share price could be the result of good instead of bad supervision. To stop too ambitious projects or even to fire high-flying executives can be in the best interest of a company and its shareholders even if share prices drop because investors learn of problems they did not know about before. However, firing managers and destroying expectations is not always or even in most cases the best course. It depends on the managers and their real performance instead of the apparent one. Good supervisors differentiate between good and bad managers and also good and bad projects and performance while they help average managers to perform better.

A perfect supervisor of supervisors would evaluate the supervisors accordingly and reward the better ones while firing the bad ones. However, such a super-supervisor normally does not exist (and if he or she existed, the normal supervisors would be unnecessary and could be replaced by the super-supervisor) such that quite simple rules are needed to choose and reward supervisors. The first rule is to do no harm, especially by setting no wrong incentives. The right incentives depend on the kind of non-executive directors (the subject of the next section). In any case, without a good performance measure it could be best to have no variable pay depending on a bad measure that would incentivise the wrong behaviour (see Dilger, 2005). An alternative to fixed payments are very long term incentives. They have the same effect of responding very slowly if at all to short term actions (but they cost more to give the

same utility to supervisors). One disadvantage of this is that supervisors get paid nearly the same whether doing a fine or a poor job. Nevertheless, this is better than rewarding the wrong behaviour as covering problems and punishing the right behaviour for supervisors like finding mistakes of the executive managers.

3. Different Kinds of Non-executive Directors

There are different kinds of non-executive directors. They have different strengths and weaknesses and also different needs for good incentives, although there are some important similarities. Sometimes a company or its shareholders can choose which kind of directors they want and sometimes they have to respect some or even a lot of restrictions in this regard.

3.1. Large Shareholders

In a way the simplest solution to any corporate governance problem is the identity of managers and owners. The one and only owner as manager of his or her own company has no incentive problems (at least in an economic sense while there could be motivation problems to be analysed psychologically). A stock company is usually larger, having several owners and managers. However, if there are only a few large shareholders and they take all higher management positions, the incentive problems should be low. Everyone has a high interest in the success of the company and also in supervising the other owner-managers that they do their part of work without taking out of the company more than agreed to. If they are not all equally well at managing a firm some can become executives and other non-executive directors.

Even if none of the large shareholders is interested in or qualified to becoming an executive manager, such managers could be hired from outside while all large shareholders supervise them as non-executive directors. They have high incentives to do this properly, at least as a group, because they own the company and participate in any gains or losses without the need for any extra pay, which they would have to pay by themselves anyway.

Individually, they could try to minimise the work of supervising and hope that some others will do it properly. Moreover, at least in large companies, large shareholders use to be rich and may be more interested in other things than working for their company or its supervision. One possibility is to look for a representative to perform this task (see the next subsection). Another possibility is to sell most shares such that this particular company is less important

and the individual portfolio more diversified. In this case there remain less or even no large shareholders while a lot of small shareholders come into existence. They have more difficulties and fewer incentives to assert themselves. While large shareholders are good supervisors in regard of their own interests, they often have different interests from small shareholders or could even harm them such that the latter should look for good representatives for themselves.

3.2. Representatives of Shareholders

Large shareholders can represent themselves but may hire someone else to do it for them who has more expertise and time to do it properly. Small shareholders always need someone to represent them even if they choose someone out of their midst. In practice, they are often not represented at all or they are represented by someone with other interests like a banker (see next subsection) or by a fund manager. In any case, it is important to align the interests of these representatives with those of the shareholders. However, at least for large shareholders and funds this is more their own task than that of the company. As long as these hire and pay their representatives, those will do more or less what they are paid for. A generous salary will be enough for such representatives, perhaps with the opportunity to be promoted for very good results and the possibility to be fired for very bad performance and especially disloyal behaviour.

3.3. Representatives of Banks and Other Stakeholders

There could be representatives of banks and other stakeholders (for employees see the next subsection) like large suppliers or costumers on the board as non-executive managers (or on the supervisory board in countries with a two-tier system). With proxy voting like in Germany the banks can exercise the votes of most small shareholders. Even without that it could be in the interest of a company and its shareholders to have representatives of its most important business partners on its board. First they can consult the executive managers. Second they can warn the shareholders of looming problems concerning their managers, especially bad relations with the companies that are represented by these board members. These representatives are chosen, although not officially elected, by their sending companies and can be expected to represent more their interests than those of the receiving company and its shareholders (see Dittmann, Maug and Schneider, 2010, for a negative effect of bank representatives in Germany on the performance of receiving companies while their banks profit). However, their pay is of no mayor concern for the receiving company, while the

sending company can pay them a salary as other employees (see last subsection) or send its own executive managers.

3.4. Representatives of Employees

A special group of stakeholders of any company are its employees. In some countries, for example Germany, there is co-determination by law (for an overview in English see Page, 2009). Depending on a company's size and legal form none, a third or even half of the seats of the supervisory board are going to representatives of the company's employees and unions in general. However, even a parity of seats is impure because in case of a draw the vote of the chairman of the supervisory board who comes from the shareholders' side is decisive (only in large companies in the coal and steel industries there is pure parity with a neutral chairman). This means that the shareholders' side can always win as long as it votes uniformly.

As a consequence, all shareholder representatives have to be more loyal than creative and the real decisions are not made at the official board meetings but before. In a way the same is true for the labour representatives. They are more powerful when voting as one although they cannot win by their own. In practice, most decisions are backed by all sides which made deals before. In any case, the labour representatives get the same pay as those of the shareholders but the former give most of it away to their union. Accordingly, at least half of the pay of the entire board has no incentive effect and finances the labour union instead. This is an argument for modest pay and perhaps more fringe benefits than direct payments, at least in countries with this kind of co-determination.

3.5. Former Executive Managers

One important kind of non-executive directors are former executive managers. Especially the CEO or chairman of the executive board often wants to become chairman of an integrated or supervisory board when retiring. One advantage is his or her expertise and knowledge of the company. However, he or she has an incentive to hinder radical change affecting his or her legacy and especially to cover any old mistakes. The new CEO or chairman of the executive board should be free from this influence of the past. To keep the expertise of former executives it is better to hire and pay them as consultants than as non-executive directors.

3.6. Executives of Other Companies

Executives of other companies can also be non-executive directors. If they do not represent other stakeholders (see subsection 3.3.) they just give valuable knowledge and advice. They earn enough as executives and need only symbolic compensation. They can also win reputation and networking opportunities. Both do not cost money and have the advantage that these directors are interested in good results (but they may leave when things get tough, see Fahlenbrach, Low and Stulz 2010). A possible disadvantage is a lack of time because they have to run their own companies. However, there are synergetic effects and they are often good delegators.

3.7. Academics and Others without Material Interests

Finally, academics, politicians and other persons without material interest in the respective as well as any other company could be non-executive directors. They bring additional knowledge, perspectives and/or connections to the board and thereby the whole company (for politicians see Faccio, 2006). Normally, they are not especially motivated by monetary pay and are very pleased with quite moderate sums. Academics are mainly interested in learning something or even getting data for their research, whereas politicians have reputational concerns. This is no problem as long as they do not follow a political agenda and want to please their voters at the expense of the company.

4. Conclusion

Supervision is different from execution and supervisors have a different task from the executive managers they are supervising. Thus they need also other incentives. Especially paying them by the short-term performance of the company is no good idea. A closer look at the different kinds of non-executive directors also reveals that none of them is primarily motivated by their pay from the company. They should get something for their work but it should be fixed or very long-term, if not consisting of mainly fringe benefits and status goods instead of money.

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