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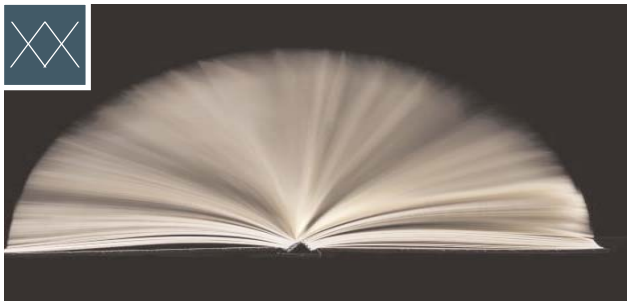
Book review

Richard Donkin

# Winner takes all



It is not just market forces that determine pay and reward. Cultural factors and dynamics play a strong part, according to a new book by Sandy Pepper.



Why has executive pay increased so much since the early 1990s? Why is it higher in the UK than elsewhere in Europe? Why do French executives get paid more than Germans? And why do the pay recommendations of remuneration committees sometimes face rejection among shareholders?

All these questions and more have been tackled in a new book by Sandy Pepper, a partner with PricewaterhouseCoopers HR services and a specialist in executive pay. The book, *Senior Executive Pay: Key Models and Practices*, attempts to throw some light on the kind of considerations that remuneration committees involve themselves in when deliberating over the complex relationship between performance, motivation, incentive and reward.

The exacting role of remuneration committees of public companies that, since 2003 in the UK, have held responsibility for setting reward packages of executive directors and chairmen is being exposed to ever increasing degrees of scrutiny inside and outside the boardroom.

This means that sound information and advice is crucial if committees are to make equitable arrangements for directors' pay.

But pay data alone goes only so far. Unlike most discussions of executive pay, Pepper's analysis looks beyond pay structures and examines the psychological, contextual and cultural influences on the way that senior executives relate to their reward packages.

A broad understanding of ideas such as agency theory, game theory and tournament models is useful, he believes, if businesses are to understand the dynamics that have underpinned senior reward strategies in the past.

He explains, for example, how the 'winner takes all' philosophy most

noticeable in professional sport has entered the corporate market, with many companies reasoning, like football managers, that they will need to pay higher wages than their competitors to attract the best players.

The problem is that when all businesses think the same, particularly when they are guided by pay data with sector comparisons, they will not want to pay their best people at rates in the lower pay quartiles. This has led to a ratcheting-up of senior pay proportionally far beyond general pay increases.

As he notes, however, irrational human behaviours tend to undermine economic theory. There are few better illustrations of this than that demonstrated by a research experiment called 'the ultimatum game', where two players are given the opportunity to share £100.

Neither player knows the other. One player is given the power to decide how the money will be divided, but he knows that if the other player rejects his decision, neither will benefit.

When the first player decides to keep an overwhelmingly large proportion - say 90% - for himself, the second player tends almost always to reject the smaller sum, even though it is more than he would have had beforehand. The game shows that most people are prepared to make a financial sacrifice in order to establish ingrained values of fairness and trust.

Culture matters too. When the game is played in the US, lower offers are more frequently made and accepted. In Japan the deciding player tends to offer 50%. This may help to explain why pay distributions for executives vary widely between countries and why executive pay in the US has outstripped levels in other countries.

In an insightful and informative analysis, Pepper has succeeded in marrying the dry detail of corporate governance guidelines with the kind of motivational analysis that should prove a welcome asset in boardroom deliberations over executive reward.

## Book details

*Senior Executive Reward: Key Models and Practices* by Sandy Pepper is out now, published by Gower Publishing Ltd, and priced at £45.

Richard Donkin is an author and journalist specialising in human capital. He writes for the *Financial Times*.