Thinking allowed: pay and diversity

A selection of academic papers and speeches – December 2016

Here is a selection of recent academic papers and speeches on pay and diversity that we have read, sifted and translated so that you don't have to. This selection includes research on why the problem with executive pay could be worse than you think; a history of executive pay since the 1930s; how stock awards reduce systemic risk in banking; the limitations of 'say on pay'; how social networks between analysts and fund managers affect their investment decisions (and why female board members in Singapore play golf); and why the financial services industry needs to address diversity.

The mismeasure of Mammon: uses and abuses of executive pay data

If you thought executive pay was a problem, think again. It could be even worse than it looks. A working paper from the Institute for New Economic Thinking suggests that US executive pay is widely mismeasured by regulators and companies, and routinely misreported by the media (for example, both The Wall Street Journal and the New York Times recently wrote that executive pay in the US decreased in 2015, when it actually increased).

The problem is that regulators require companies to disclose an estimated fair value of stock awards to senior executives at the time of the award, instead of the actual realised gains on those stock awards. The paper argues that regulators such as the Securities & Exchange Commission and the Financial Accounting Standards Board – as well as many critics of excessive pay - are 'obsessed' with fair value (even if companies also have to disclose the subsequent realised gains) leading to a systematic and substantial understatement of what executives actually earn that has become hard-wired into the debate on pay.

For example, the paper shows that in 2015 the average total pay 500 highest paid executives in the US based on estimated fair value was $19.3m. However, the average pay for the same executives based on the actual realised gains on their stock awards was $34.3m – nearly 80% higher than the widely reported numbers.

The right data is there, it's just a matter of picking the correct figures. In order to address the argument on pay – let alone win it - regulators, companies and the media should focus on more accurate and consistent numbers.

Research paper by Matt Hopkins and William Lazonick Institute for New Economic Thinking, Working Paper No. 49, August 29, 2016

A brief history of executive pay: what worked?

Why has executive pay risen so much faster over the past few decades than growth in GDP per capita, corporate earnings, total shareholder returns, and average wages?

A forthcoming paper from UCLA, Cambridge and Temple University dives into the history of executive pay in the US to investigate why it was so modest and so stagnant from 1940 to mid-1970s, a period when US businesses were thriving. For example, the pay for CEOs of listed US companies in the mid-1980s was 5% lower in real terms than in the mid-1930s, and it only grew at 0.8% a year in real terms between 1950 and 1975. Meanwhile, the ratio of CEO pay to median worker pay has ballooned from 17 times in the late 1940s to more than 300 times today.

The paper challenges the traditional explanation – boosted recently by the work of Thomas Piketty – that the growth in pay over the last few decades is the result of the fall in levels of income tax. In the

1950s, for example, the top marginal rate of income tax in the US was 91% and it only fell below 50% in the late 1980s.

Instead the paper argues that a combination of trade unions and cultural norms kept pay in check for most of the post-war period. Unions were able to put downward pressure on pay because companies used pay as a bargaining chip during labour negotiations. This effect has diminished in line with the decline in union membership.

The change in social norms and the market for managerial talent and social norms had an even bigger impact. Unlike the common perception from the 1990s onwards that senior executives have abnormal talent and make a huge individual difference to the companies they run, in the1940s to 1970s, CEOs were viewed more as bureaucrats with interchangeable talents that could be easily found elsewhere. In addition, there was a 'team first' attitude and a fear of being stigmatised as being greedy in the aftermath of the Great Depression and World War II.

The paper provides an excellent summary of the history of executive pay in the 20th century and is worth reading for that alone, but the authors admit defeat when it comes to potential solutions: 'There is probably little appetite for a return to the orderly but potentially demoralizing uniformity of mid-20th century corporate life'.

Research paper by Steven. A Bank (UCLA), Brian R. Cheffins (Cambridge) and Harwell Wells, Temple University Beasly School of Law Legal studies research paper No. 2016-37, August 2016.

The external effects of bank executive pay: liquidity creation and systemic risk

It is a truth almost universally acknowledged since the financial crisis that increasing the amount of bankers' bonuses that are paid in stock and extending the period over which those awards are paid will make the banking system safer. A recent paper in the US seems to confirm that in the period running up to the crisis at least, paying a higher proportion of bonuses in stock had precisely that effect.

The paper by researchers the University of Kansas and the University of Louisville analysed the link between bonus structures and external risks to society in the form of excess liquidity creation and systemic risk at US banks between 1994 and 2010.

They found that where the wealth of the chief executive of a bank was highly correlated with the performance of a bank's share price – a measure of how much of the CEO's pay was in the form of stock awards – there was an associated reduction in liquidity creation of 3% and nearly 7% fall in systemic risk. In other words, bank CEOs seemed to become more risk-averse when more of their wealth is on the line.

On the other hand, the researchers found that where the wealth of a bank CEO was highly correlated with the volatility of the share price – a measure of how much of their pay was in the form of stock options – there was an associated increase in both liquidity creation and systemic risk. Or: CEOs appeared to take more risk when they had more to gain and less to lose.

While the paper suggests that high levels of stock awards may reduce at the margin the amount of liquidity created by banks, it suggests that this trade-off is worth it in order to reduce systemic risk.

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Rethinking capital markets

Research paper by Robert De Young and Minjue Huang- SSRN, Working paper, September 15, 2016

Its findings are echoed in a recent paper from researchers at the Chicago Booth School of Business and London Business School on the impact of pay regulation on financial firms in the UK.

The research found that the introduction in 2009 of the UK Remuneration Code, which aimed to tackle short-termism and increased the proportion of bonuses that should be paid in stock, had a positive impact on shareholders returns at UK banks. But the introduction of the EU bonus cap had a negative impact on returns. While UK banks deferred more bonuses and reduced risks by more than their US counterparts, they experienced higher levels of CEO turnover and pay structures at UK banks became more complicated relative to non-financial firms.

Research paper on regulating pay by Anya Kleymenova and A. Irem Tuna, Chicago Booth Research Paper No. 16-07, March 2016)

Does 'say on pay' matter? Evidence from the German experiment

'Say on pay' is viewed by many as the potential cure for addressing excessive executive pay. But does giving shareholders a say on how much executives are paid actually work?

A working paper from Goethe University Frankfurt investigates the impact of say on pay legislation in Germany that was introduced in 2009 on 34 German blue chip companies in the Dax index, using a dataset of 1,669 executive pay packages for the period from 2006 to 2014.

First, the study found that the main determinants of pay for management board members of Dax companies were performance measures such as return-on-assets and EBIT, while ownership concentration – a measure of how effective shareholders might be in keeping pay in check – had little or no impact.

Second, the paper found that low shareholder support in say on pay votes had minimal an impact on the overall pay of incumbent board members, which is perhaps not unexpected given German contract law. However, low support from shareholders appears to have a significant impact on the level and structure of the pay of newly-appointed management board members for both total and variable pay. On that basis, given the relatively low rates of turnover of senior executives, it could take many years for 'say on pay' to even begin to have the impact that its supporters believe it could have.

Research paper by Tobias H. Troeger and Uwe Walz, Goethe University Frankfurt SAFE Working Paper No. 125, July 11, 2016

Friends in need are friends indeed: an analysis of social ties between financial analysts and mutual fund managers

Social networking can do more than just increase your chances of landing a job: if you're a fund manager or analyst, it might also affect your investment decisions.

A working paper by researchers at the Chinese University of Hong Kong investigated how the social ties between sell-side analysts and fund managers that were developed at universities, business schools and companies in China affect fund managers' investment decisions and analyst recommendations.

They found that social connections mattered. Fund managers are more likely to take a significant position in stocks covered by analysts with whom they have social connections and found some evidence that they generated higher returns on stocks covered by analysts with whom they were connected.

How come? First, analysts are more likely to do site visits to firms whose stocks are held by their connections. Second, analysts are more likely to issue optimistic stock recommendations on stocks held by their connected fund managers. And finally, fund managers are more likely to cast favourable votes for their connected analysts in star analyst elections and their companies are more likely to allocate trading commissions to these analysts' brokerages.

In other words, the alumni networks from universities and business schools can act as a closed club. This could have significant implications for diversity in the industry. If analysts and fund managers from the same social networks scratch each others' backs – unwittingly or otherwise – it could raise the barriers to entry for people from outside of these networks.

Working paper by Zhaoyang Gu, Guangqing Li, Zengquan Li, Yong George Yang- Chinese University of Hong Kong (CUHK) Business School Working Paper, October 2016

The paper echoes a depressing study in The American Economic Review that studied the link between female representation on company boards and playing golf. By cross-referencing the boards of 431 companies with data on more than 10,000 golf players, it found that just 11% of golf enthusiasts in the sample were women. However, these women were 54% more likely to sit on a board than male golfers – and more than twice as likely to sit on the boards of large companies. Do female board directors like golf more than their male counterparts? Or do they need to play golf in order to increase their chances of becoming a board director?

From Playing the Boys Game: Golf Buddies and Board Diversity, a paper by Sumit Agarwal, Wenlan Qian, David M. Reeb, Tien Foo Sing – The American Economic Review, May 2016)

The Diversity Project - introductory speech by Andy Haldane, chief economist at the Bank of England

Here is a short five point summary of a speech by Andy Haldane, chief economist at the Bank of England, on diversity and inclusion in financial services at the launch of the Diversity Project, a five year initiative launched by the Investment Association to increase diversity and inclusion in the asset management industry:

1) Playing catch-up in financial services
When it comes to diversity, the financial services industry is not a leader. Despite a steadily increasing trend of female and ethnic minority representation in the workplace, there is limited evidence of increasing representation at the senior executive and board level. For example, according to recent work by PwC women make up 60% of all employees, but only 25% make it to middle-management and only 19% to senior management in financial services.

2) Diversity is still seen as a touchy-feely issue
Although progress has been made recently, mainly driven by initiatives such as the 30% Club, Jayne-Anne Gadhia's review of gender diversity, HM Treasury's Women in Finance charter, and John Parker's review of ethnic diversity, diversity is largely seen as a CSR-philanthropy issue rather than a catalyst for creativity and productivity. In the education system, training, recruitment, promotion and performance systems remain full of biases and barriers.

3) The benefits of diversity through time

Historically, from Ancient Greece and Rome to Elizabethan Britain and post-revolutionary France, every great transformation in innovation and well-being was the result of different cultures, disciplines, religions and experiences, which among historians is known as the 'Medici effect'. Nowadays, the reason why countries, and organisations are thriving and some cities are rapidly growing innovation hubs is also diversity. In addition, a lack of diversity, which amplifies biases like hubris and groupthink when it comes to decision-making, was the main reason why banks, regulators, central banks and academics failed in 2008.

4) The current environment is an opportunity and not an excuse

The current environment is characterised by rapid technological change, rising inequality and lack of trust in big banks, business, and government. It might seem overwhelming to add diversity into that mix and in some organisations there are already signs of fatigue. However, it would be wrong to delay further the push to a new frontier as this is exactly the environment where diversity can bring the largest gains and organisations can thrive.

5) Four steps to push the agenda forward

First, we need to look deeper into existing initiatives and fill the gaps such as the persistent gender pay gap, and women and ethnic minority representation in senior management

Second, it's time to do a better job in understanding and measuring the more difficult dimensions of diversity – such as the cognitive and sociological dimensions - and publish the metrics.

Third, we need to reform recruitment processes as the current methods may disadvantage those who had less resources and opportunities due to their parents' income, or those who are not socially-skilled or are afraid of interviews due to personality-type or brain circuitry.

And finally, there is a need to focus on social immobility, which has its roots in our education system and which leads to an immense waste of potential talent. Evidence show that the highest IQ individuals from the most disadvantaged backgrounds are surpassed by the lowest IQ individuals from socially privileged backgrounds.

You can find out more about the Investment Association's Diversity Project here