SECTION 2 Management in Firms and Organizations

Executive Compensation in the Netherlands

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Abstract

This paper shows the recent developments in the structure of Dutch executive pay contracts. An empirical study based on remuneration data on the executive board members of 71 Dutch listed companies over the period of 2002-2004 has revealed a number of clear trends in this area. This paper demonstrates that the political interference in compensation practices, for example in the form of corporate governance guidelines, has had a great impact on the design of compensation structures, but often at the expense of the economical efficiency of these arrangements. The main objective of this study is to increase insights into Dutch executive compensation arrangements and the way in which these have evolved under the influence of corporate governance requirements.

Key words: Dutch executive pay package; remuneration; internal control mechanism.
JEL Classification: M14, M52.

Introduction

In the past decades a considerable amount of research has been conducted into the compensation arrangements of top executives. This research has, however, mainly focused on data on compensation practices in the United States and the United Kingdom. Naturally, this made sense; compensation data are widely available here, and in these countries the compensation practices are the most developed ones. In addition, the economic importance of the US and the UK in the world economy has made these countries the most relevant places to conduct research into this subject. Only limited efforts have been made to go beyond Anglo-Saxon compensation data and review executive pay arrangements in, for example, continental Europe (for exceptions, see e.g. Conyon and Schwalbach, 2000). This strong focus on Anglo-Saxon compensation practices has, therefore, neglected the structures and trends in executive compensation in other countries.

Since a couple of years now, Dutch executive compensation and corporate governance practices have been the subject of a heated debate. At the same time, the Dutch corporate governance environment has profoundly changed under the influence of the accounting scandals in the beginning of the 21st century. The prime exponent of this changing corporate governance environment was the implementation of the Dutch Corporate Governance Code in 2003[1], more commonly referred to as the Tabaksblat Code. This code has laid down a number of principles concerning the remuneration policy of listed firms and can be considered as one of the most detailed corporate governance codes in Europe.

In collaboration with Hewitt Associates[2] we conducted an empirical study with the prime objective to present the actual facts on executive compensation in the Netherlands. In this paper, we will discuss the results of this study and place them in a theoretical framework.

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[1] See: www.commissiecorporategovernance.nl
[2] See: www.hewitt.com

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First, we will present the methodology and our research findings, which are based on compensation data on the executive board members of 71 Dutch listed companies over the period of 2002-2004. The analysis will show some clear trends and developments in the structure of the executive pay packages.

Second, we will discuss two specific subjects within the executive compensation research, relating to the effectiveness of executive compensation arrangements. We will deal with both the value of incentive plans and the perverse incentives that can result from them. For this purpose we conducted an extensive search within the existing literature on executive compensation, and this article presents our main views and findings.

Finally, we will draw some conclusions on the state of the Dutch executive compensation, expected future developments and the effectiveness of (Dutch) executive compensation arrangements.

Agency theory has greatly influenced the academic research on executive compensation (Daily et al., 2003). Since the implications of this theory are also reflected in many compensation arrangements, this approach is still the appropriate point of departure for studies on executive compensation, as it also has been in this study. In the next paragraphs we will give an outline of the basics of agency theory and its consequences for remuneration practices. Subsequently, we will specify our discussion from agency theory to the characteristics of the (rapidly changing) Dutch corporate governance system.

1. Concepts and Methods

The definition of compensation used in this study is that of 'flow compensation'. Executives compensation is based on three primary mechanisms: a) flow compensation, which is the sum of the executive's annual base salary, the annual bonus, LTI grants, benefits and perks, b) changes in the value of the existing equity portfolio of the executive, and c) the possibility of changes in the market's assessment of the executive's human capital (Core et al., 2003; Jensen and Murphy, 1990). The use of flow compensation means that changes in the value of share and stock option holdings, built up in previous years, as well as gains from option exercises and share sales have been left out of the analysis.

The executive pay package consists of different components. The fixed part of the compensation package contains the base salary, pension benefits, other benefits, perquisites (perks) and severance arrangements. The short-term variable part consists of the annual bonus plan. The long-term variable part includes all equity-based compensation (option and share grants and deferred bonus plans) and long-term cash bonus plans. All equity-based compensation grants have been valued on the basis of a Monte Carlo valuation model, resulting in fair value estimates. Pension benefits, other benefits and perks have also been valued.

Theoretical Concepts

In order to provide a theoretical framework in which the results of the empirical study can be interpreted, we chose to conduct a literature study. The empirical study focuses on remuneration practices at 71 Dutch listed companies. Since 2002, all Dutch companies that are listed are required to disclose the remuneration figures of the individual members of the executive board in the annual accounts. The number of companies that are listed on the Dutch Stock Exchange ('Euronext Amsterdam') is however rather limited (approximately 150 companies) and the differences in firm size among these companies are considerable. Since remuneration practices are only reasonably developed at large companies, the relevance of the results and the comparability with other studies would decrease if all, and consequently many small, companies were included. Therefore a selection of the most prominent and largest companies was made, which has resulted in 75 companies.

For this literature overview we selected subjects that are related to the assessment of the effectiveness of Dutch executive pay arrangements. The effectiveness of executive compensation has been

defined as (1) to attract, (2) to retain, (3) to motivate, and (4) to reward the executive board. These measures of effectiveness are based on the objectives of the remuneration policies of companies as stated by them in their remuneration reports. Of the companies that report the objectives of their remuneration policy (n=63), 95% mention 'to attract' as one of their objectives, 94% 'to retain', 71% 'to motivate' and 21% 'to reward'. This last percentage is rather small, and one could argue that rewarding an executive is not an actual objective of the remuneration policy, but merely a consequence of the motivation objective. In order to motivate an executive beforehand, one should reward him or her afterwards. This is indeed true and probably explains the rather low percentage of companies that specifically mention 'to reward' as an objective[1]. On the other hand, one *can* reward an executive without the objective to motivate him. If, for example, it is not communicated beforehand that the possibility of a bonus payout exists, but the executive is offered one anyway (like an additional one-time bonus based on excellent performance), this bonus initially did not have the objective to motivate the executive, but merely to reward him or her for excellent performance[2]. Furthermore, if the assumptions about the motivational aspects of incentive pay are altered, i.e. the view that incentive pay does not necessary motivate executives[3], one could argue that incentive plans are merely a cost-efficient (or even inefficient) way to reward an executive[4]. An additional problem with ignoring the reward objective is that it directly reflects the effectiveness of the motivation objective. If executives are not rewarded adequately or on the wrong basis, they will surely not be motivated. It is therefore necessary to assess the effectiveness of the motivational and reward goal independently, however without ignoring their interrelatedness.

These four measures of effectiveness all have a different influence on the remuneration structure. The first two goals, 'to attract' and 'to retain', are in general related to offering a 'competitive' compensation package, which is primarily focused on the level of pay, although the structure of the pay package might also play a minor role[5].

Adequately rewarding an executive is interrelated with all other objectives and therefore interwoven with all other subjects. On the other hand, issues that also play a role are the incentive plan design, a fair performance setting, and performance measurement processes. Badly designed incentive plans might reward an executive on the basis of the wrong incentives or events out of his or her control. Managerial entrenchment may furthermore cause the executive to be rewarded for non-existing performance.

2. Research Results

This section discusses the different components of the executive pay package. The structure of the pay package is in most cases similar among all members of the executive board. All executives are usually eligible for the same incentive plans. Differences mainly exist in the case of retirement benefits and other special benefits and perks offered.

Base Salary

Despite an increasing focus on variable pay, base salary is still the prime component of the executive pay package. Base salary is risk-free income and therefore valued highly by executives. Furthermore, since the annual bonus opportunity and LTI grant are often set as a function of the base

[1] It is furthermore observed that many of the companies are focused on the reward objective, rather than on the motivation objective.

[2] Of course, one could argue then that this one-time bonus is offered to motivate the executive to excel again in the next performance period. However, this should not necessarily be the objective of the bonus.

[3] In section III an overview is given of this point of view.

[4] For example, in the case of an annual bonus plan, the company only has to spend cash if its performance is adequate, while the expense is delayed until the end of the performance period.

[5] For example in the sense that the more entrepreneurial managers may favour a highly leveraged pay package (large equity incentives) and the more risk-averse managers a higher base salary and more benefits. Of course, also other factors determine whether a manager will join and stay at a firm, such as job pleasure, esteem, power, ambition, reputation of the company, job safety, career perspectives and work environment. Pay, however, especially at this hierarchical level, is likely to have a considerable influence.

pay, increases in the latter automatically lead to increases in the first. Also pension benefits and severance arrangements are in many cases based on the level of base pay. There are examples of executives in the US and the UK that do not receive any base salary but solely variable pay. All executives in this study, however, received a fixed base pay. The primary goal of base pay, as part of the total pay package, is to attract and retain executives.

Annual Bonus Plans

Under the annual bonus plan executives are rewarded a sum in cash based on the performance of the firm in the financial year in question. In the period of 2002-2004 all except one of the companies offered their top executives an annual bonus plan. Ever since the introduction of the Tabaksblat Code, a lot more information has been published about the structure of annual bonus plans.

On the basis of the data available we could identify a number of types of bonus plans. The first and most frequently adopted type (in 84% of the companies in 2004) is typified by Murphy (1999) as the 'typical' bonus plan. This is a bonus plan with an 'at target' payout expressed as a percentage of the base salary for achieving the performance standard set, a 'minimum bonus' paid in the case of a threshold performance (usually expressed as a percentage of the target bonus) and a 'maximum', which limits the total payout. The range between the threshold and the maximum is called the 'incentive zone', in which the bonus payout increases incrementally with increased performance (Murphy, 1999). Other bonus plans are plans that pay a fixed amount for each percentage point by which a certain threshold performance is exceeded (8.6% of the companies) and standard profit sharing programs (5.7%). In one example, a discretionary bonus, which is not based on previously-determined and measurable targets, was granted at the end of the year by the members of a supervisory board. In general, the part of the bonus that the supervisory board can determine on a discretionary basis is limited to an individual or 'qualitative' part of the total bonus opportunity. This is mostly due to the Tabaksblat Code, which specifies that *'the variable part shall be linked to previously-determined, measurable and influenceable targets'*.

Murphy (1999) identifies three basic components of executive bonus plans: performance measures, performance standards and the structure of the pay-performance relationship.

Performance Measures

The information published by the companies that use performance measures indicates that they have all adopted financial performance measures in their bonus plans. These financial measures make up on average 83% of the potential bonus payout. Of these companies, 31% has solely adopted financial performance measures. When companies also use non-financial performance measures, the financial component of the bonus makes up an average of 72% of the potential bonus payout.

A clear trend is the increase in the use of both individual and qualitative performance goals. Examples of the latter can be the 'strategic orientation' of the company, 'policy progress' or 'team performance'. Although these performance measures can be quantified, in practice they usually have a rather discretionary character. In 2002, only 17.9% of the companies had adopted individual measures and 15.4% qualitative measures. In 2004 these figures had increased to 49.2% and 27.7% respectively. If present, these measures make up an average of 28% (average) of the bonus opportunity.

The number of different performance measures has increased over the past years. In 2002, still 61% of the companies had adopted only one performance measure, whereas in 2004 this had decreased to 37%, which means that 63% of the companies used two or more performance measures. These multiple measures are in most cases 'additive'. This means that performance based on different measures is 'split up', as a result of which each measure can technically be treated as a different plan.

The most popular performance measure is net profit, which is adopted by approximately 30% of the companies. Earnings per share (EPS) (22.6%), return measures[1] (21%), profit measures before

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[1] Examples of return measures are ROCE, ROA and ROE.

taxes and/or depreciation[1] (21%) and sales growth (16.1%) are other widely used measures. The only clear trend in the adoption of specific performance measures is a decrease in the use of EPS, which was still used by 33% of the companies in 2002, but by only 22.6% in 2004. Furthermore, there has been an increase in the number of 'soft' measures in areas such as strategic development and corporate social responsibility.

Performance Standards

Murphy (1999) makes the following categorization in performance standards: 'budget' standards, 'prior-year' standards, 'discretionary' standards, 'peer group' standards, 'timeless' standards and 'cost of capital' standards. The number of data is, however, too limited to draw any conclusions about the performance standards that are being used in bonus plans. There are hardly any data available on specific performance goals and targets. Companies simply do not publish data on these issues because they contain competitive-sensitive information. We will therefore not discuss performance standards in detail.

Pay-Performance Structure

The pay-performance structure usually involves a payout scheme that matches a certain performance with a bonus payout, usually expressed as a percentage of the base pay. A typical scheme involves a threshold performance, below which there is no bonus payout, an 'at target' performance, paid out when the performance goals are met, and a 'cap', which limits the maximum bonus payout. The pay-performance relationship between threshold, at target and cap is in most cases linear.

In 2004 the median at target bonus of CEOs was 60% of the base salary. For CFOs this was 50% of the base salary and for the other members of the board 58%. Of all companies, 68% sets the same target bonus level for all members of the executive board, whereas 32% sets different levels for individual members. This usually means a higher target bonus for the CEO, but also in some cases higher ones for one or more of the other members, usually the non-Dutch executives. At the larger companies the bonus opportunities are in general higher than at the smaller enterprises (expressed as a percentage of the base pay). At target the bonus opportunities have been fairly consistent over the years; however, a lack of data of earlier years has prevented us from drawing any hard conclusions.

Companies rarely publish the bonus payout at the threshold performance level; although most companies indicate that a threshold level is existent. Furthermore, a few companies indicated that in the case of clear mismanagement a so-called 'fairness assessment' can be applied. This means that the supervisory directors can decide to cancel a possible bonus payout because of this mismanagement, even though the performance goals have been met. This 'fairness assessment' however, will in practice only be applied in exceptional cases (such as in fraud situations).

During our data period the median maximum bonus that could be earned was 63% of the base pay. This figure, however, cannot be compared with that of the at target bonus, since a larger number of different (also smaller) companies published data on the maximum bonus compared to those who reported on the at target bonus[2]. When looking at the companies that published data on their at target as well as their maximum bonus opportunities, we can observe that CEOs can earn an average of 53% on top of their at target bonus (which equals 34% of the base salary).

Stock Options

A stock option gives the owner the right to buy or sell an asset at a fixed price on or prior to a given date. Stock options grew increasingly popular in the eighties of the previous century, first mainly in the United States, but later also in Europe. Ever since the late nineties, stock options have constituted the largest part of the US executive compensation package and have also regularly formed part of the Dutch executive compensation package (however to a smaller degree).

[1] For example EBIT and EBITDA.

[2] Of all companies, 41% published data on the at target bonus compared to 70% that published data on the maximum bonus.

Their popularity has been attributed to the absence of charges against accounting income, favourable tax treatment and the positive incentive effects resulting from the close link between compensation and share price development (Huddart and Lang, 1996). Furthermore, stock options provide an incentive to act in the long-term interest of the company, since they usually can only be exercised after the expiration of a vesting period. They can also help attract highly motivated and entrepreneurial employees, because payout is based on future performance, and the rewards can be much higher than with normal cash compensation (Hall and Murphy, 2003). When an option 'vests' it means that the option can be exercised. The vesting of stock options can be dependent on the attainment of performance conditions, or on the expiration of a time period. Options are typically forfeited if the executive leaves the company before vesting, although accelerated vesting is also a common plan characteristic.

Despite its prevalence in the last decades, in recent years new forms of equity-based compensation[1] have gradually replaced the stock option in the long-term pay package. For a number of years now, a clear shift from the traditional stock option plans to these other forms of equity-based compensation, and in particular performance shares, has taken place. In 2002, still 71.8% of the companies granted stock options to their executive board members. In 2004 this number had declined to 66.2%. Options can be granted within the context of a stock option plan, a performance unit plan (in combination with shares and sometimes cash) or a one-off grant, for example as a sign-on award, although these grants are not included in this analysis. The number of companies with a traditional stock option plan declined from 71.8% in 2002 to 57.8% in 2004. Only one new option plan was introduced in 2003, and none in 2004.

Option Plan Structure

The structure of traditional stock option plans has changed significantly in recent years. This is a clear result of the implementation of the Tabaksblat Code and the changed corporate governance climate. The most important trend is the addition of performance conditions to the vesting (or grant size) of the grant. In a traditional option plan, options could, if in the money, usually be exercised immediately after receiving the grant. In some cases only time restrictions applied to the vesting of the options, which means that the options could not be exercised until an initial period had expired (usually three years).

In 2002, only 28% of the companies (with an option plan) had performance restrictions attached to the vesting of the options. In 2004 this number had increased to 49%. Including the companies that had performance conditions attached to the determination of the grant size, 67% had in some way or another performance conditions as part of the option plan. The expectation is that in the coming years all other companies that have not attached any performance restrictions to their option plans yet, will implement these or will switch to performance shares or units. Earnings per share is the most popular performance measure in option plans (37%), followed by Total Shareholder Return (33%). The EPS performance condition usually involves a hurdle (e.g. 6% EPS growth) that has to be met to make the options exercisable. TSR is usually used in a relative context; the TSR of the company is measured and compared to those of peer companies, after which a ranking is determined that corresponds with a certain vesting percentage, usually defined as a percentage of a target grant (the whole represents the payout scheme).

The average term of an option was 7.26 years in 2004, slightly longer than in 2003 (7.08) and in 2002 (6.87). Most option grants had a term of 5 years (27% in 2004), followed by a ten-year term (24% in 2004). A small trend can be distinguished toward options with longer terms. Of all option grants, 94.3% was granted 'at the money' (2004), which means with an exercise price the same as the share price at the grant date. The rest, 8.7%, was granted at a premium. Some companies granted options with different exercise prices to different executives. The percentage of option grants that was granted 'in the money' in 2002 was still 16%. No options were granted at a dis-

[1] Other long-term incentive variants are performance share plans, performance unit plans (a combination of options, shares and cash), deferred bonus plans and long-term cash bonuses.

count (with an exercise price lower than the market price at the grant date), which is in line with the Tabaksblat Code.

Performance Shares and Restricted Shares

The past few years, performance shares, also sometimes referred to as Long-Term Incentive Plans (which is used here in a broader context) have grown increasingly popular in the Netherlands. First introduced in the UK on a large scale, during which time they were not yet very popular in the US, performance shares have since then slowly replaced stock options as the preferred form of long-term incentive in the Dutch executive pay package. Performance shares are usually granted as part of a performance share plan or performance unit plan (in combination with options and/or cash). Under a typical performance share plan, conditional shares are granted that vest after a performance period (usually three years). The degree of vesting depends on the attainment of the performance condition. In some case an additional vesting period follows the performance period. Restricted shares are similar to performance shares, but have no performance conditions attached to the vesting of the shares. Only a vesting period restricts the sale of the shares. Restricted shares are not common in the Netherlands and are in most cases only awarded as part of a sign-on bonus.

Of the companies studied, only 9.9% granted performance shares in 2002. By 2004 this percentage had increased to 35.3%, of which 8.5% of the shares formed part of a performance unit plan. It was to be expected that by 2005 the number of companies with a performance share plan would have risen to 42.3% and in total 57.8% of the companies would award performance shares. This means that in 2005 for the first time the majority of companies would prefer granting shares to granting options. In 2004, 48% of the newly introduced long-term incentive plans were performance share plans and 13% performance unit plans. In 2003, these percentages were 10% and 30% respectively. It has to be noted, however, that the number of datapoints was much smaller in 2003.

Performance Share Plan Structure

In 2004 relative TSR was the most popular performance measure in performance share and performance unit plans (56%), followed by EPS (16%) and return measures (8%). Half of the performance measures that were newly introduced included relative TSR, which signals the clear preference for this measure.

Deferred Bonus Plans

In deferred bonus plans (DBPs) part of the annual bonus payout is deferred into shares of the firm, which consequently have to be retained for a vesting period of (usually) three years. After this period, bonus or matching shares are awarded, but sometimes only if the performance conditions are met. Participation in the plan can be voluntary, but is in most cases compulsory. Another form of encouraging shareholdings was the introduction of so-called shareholding requirements, which oblige executives to invest in firm shares from their own wealth.

The number of companies with a DBP has increased rapidly in the past few years. From 7% in 2002, the percentage of companies with such a plan increased to 18.1% in 2004 and was expected to further increase to 25.4% in 2005. Of the newly introduced long-term incentive plans in 2004, 22% was a DBP (30% in 2003). In almost all cases, companies had deferred bonus plans alongside performance share or unit plans.

In most cases (36%), 50% of the annual bonus payout was converted into shares. In 27% of the cases this was 25% of the bonus payout. The most frequently used matching ratio was 1:1 (83%), which means that for every share that is deferred one bonus (or matching) share is awarded after the vesting period. In 17% of the cases every share was matched with a 0.5 bonus share. In 31% of the DBPs performance conditions were attached to the number of bonus shares granted. The performance measure most frequently used was EPS (60%).

Other Long-Term Incentive Plans and Equity Incentives

An alternative for equity-based incentives are long-term cash bonus plans, which are comparable in structure with annual bonus plans, but have a term of more than one year (usually three). One

can observe a slight increase in the number of long-term cash bonus plans, from 5.6% of the companies in 2002 to 14.1% in 2004. In 2005, however, this was expected to have declined again to 12.7% of the companies. These kinds of plans are in particular popular at smaller companies. The most frequently used performance measure in long-term cash bonus plans is TSR (or stock price development). This performance measure is, however, often adopted alongside other measures, quite often qualitative measures focused on the strategic development of the firm. Other measures are EPS, net profit and the short-term bonus payout.

Another form of LTIP is associated with stock appreciation rights, which have the same characteristics as stock options but with a cash payout. Dutch companies, however, hardly these measures. Furthermore, options or shares can be granted as a one-off grant, for example as a sign-on bonus, and may therefore not be part of a specific plan. These grants do exist, but not on a regular basis; they are not commonly used.

Retirement Benefits

The executive pension plan is one of the least highlighted components of the executive pay package. The information that is published about executive pension plans is in general limited, which complicates the analysis and proper valuation of this plan. Three basic types of pension plans can be distinguished: 1) defined benefit plans (DB) based on middle pay, 2) DBs based on end pay, and 3) defined contribution plans (DC). The retirement benefits in the Netherlands differ considerably from those in the US. From the companies that published information on their executives' pension plans, 45% had a defined benefit plan based on end pay for at least one of the executives. Furthermore, 13% had a defined benefit plan based on middle pay, 35% a defined contribution plan and 15% a hybrid plan (usually a DB plan based on end pay in combination with a DC plan). A number of companies had different types of plans for individual executives.

Other Benefits and Perks

Besides retirement benefits, companies usually offer their executive board members a package of other benefits and emoluments, the latter often referred to as perquisites (perks). Examples of benefits[1] are health insurance, sickness benefit, social security insurances, lump sum death and other insurances (e.g. accident insurances). Examples of perquisites[2] are a company car, representation allowance, a telephone and a laptop. In general most of these perquisites are of relatively little value to the executive, but in some cases they are. For example, housing allowances, relocation allowances and private use of a company jet (not common in the Netherlands) can amount to a significant value. Approximately half of the companies merely give an indication (usually not more than that) of the benefits and perks they offer their executives. Most frequently mentioned is a company car (49%), followed by health insurance (45%), representation allowance (38%), housing allowance (15%), accident insurance (14%) and relocation allowance (14%). Personal loans to directors, often criticised and discouraged by the Tabaksblat Code, are hardly offered anymore. Only financial institutions still offer loans to their executive directors (often on a commercial basis or on the same terms as the other employees).

Severance Packages

In general, companies report quite poorly on severance packages in their remuneration reports. Only 44% of the companies give a clear image of what this specific arrangement entails. Four primary severance arrangements can be distinguished: a) the severance payment, which is expressed as a multiplier of a certain basis (usually only base salary, sometimes including bonuses), b) a specific formula, used to determine the size of the payments (e.g. the Dutch cantonal court formula), c) a discretionary severance payment, set by the Supervisory Board or d) base salary payments (and sometimes bonus payments), which are continued until the executive has reached the pensionable age. Of the companies that reported on their severance arrangements, 68% used a multi-

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[1] Benefits are non-cash income elements on top of the base salary and in value (directly) related to the latter.
[2] Perks are additional income elements that are not related to the base salary.

plier to determine the size of the package. The other 32% uses one of the other forms or a combination.

Besides arrangements for involuntary leave, most companies also apply special 'change of control' arrangements in case the company is being taken over. These arrangements are in most cases more lucrative than the normal severance arrangements. The idea of using special change of control arrangements is based on the possibility that executives might frustrate a particular take-over, which is beneficial for the shareholders but not for the executive, since the latter might lose his or her job as a consequence. The prospect of a lucrative severance arrangement might convince the executive to cooperate. On the other hand, one could also argue that in this way the executive gets rewarded for having conducted a clear mismanagement, since a low market value can be a trigger for a take-over.

3. The Value of Incentive Plans

The prime objective of incentive plans is to motivate executives to increase their performance by means of previously determined performance measures. In equity-based plans this usually entails increases in shareholder value. In this sense it is important to know how the executive values incentive plans, and in particular equity-based incentive plans. Since stock options and shares are a risky form of compensation, they are in general perceived as less favourable than the objective value resulting from an option-pricing model (Hall and Murphy, 2002). These option-pricing models are based on the assumptions that shareholders can diversify their portfolio and that the riskyness of the option's payoff can be perfectly hedged (Lambert et al., 1991). Since the diversification and hedging abilities of executives are limited, the value of the grant to the grantee (and consequently that of the incentives) will be less than the value to the company (costs), as indicated by a Black and Scholes calculation, the valuation method most commonly used. The ultimate value of a grant depends to a large extent on the share of the executive's personal wealth that is tied to the firm's stock price. If this is a large share, its value as perceived by the executive can be significant less than its costs as perceived by the shareholders. The value of the grant therefore also depends on the structure of the rest of the compensation package (Lambert et al., 1991). Another important variable that determines the value of the option or share to the executive is his/her degree of risk aversion (Hall and Murphy, 2002). Is the degree of risk-aversion high, the option, as a risky form of compensation, is obviously valued less than in the case of a relatively small degree of risk aversion?

On the other hand, some of this value difference can be effectively eliminated by the executives themselves; to hedge option risk, they can, for example, sell short shares that are highly correlated with the firm's shares. Executives may also be more willing to hold on to the option, if they know they have some control over the underlying asset process or possess inside information about the firm's prospects. This could offset some of the benefits of diversification (Carpenter, 1998). Core and Guay (2003) furthermore argue that if shares or options are granted as compensation, executives will not discount their value, since they allow them to rebalance their equity portfolio. In this way the grant does not create additional incentives. As discussed before, Ofek and Yermack (2000) have shown that executives typically sell previous option and share grants when receiving a new one. If, however, the equity grant is used to increase incentives, and limitations are placed on selling past shareholdings, the executive will discount the value of the grant (Core and Guay, 2003).

Vesting restrictions and performance conditions can also affect the subjective value of a grant to the executive. Since early exercise possibilities increase the perceived value of the plan, vesting restrictions will lower the value to the executive. Hall and Murphy (2002) state that the executive value to company cost ratio does decline with the number of years until an option can be exercised, but also that the value (cost ratios) is rather flat in the case of short vesting durations, which suggests that short vesting periods (two to three years) do not greatly affect the grant's value (cost efficiencies).

It would furthermore be interesting to see what the effects could be of performance conditions on both the plan's subjective executive value and on its subsequent value (cost ratio), since almost all

equity plans in the Netherlands now have performance conditions attached to either grant size determination or vesting. Although Hall and Murphy (2002) have not extended their study to performance conditions, one could argue that the perceived value, and therefore the incentives, of a plan decline when additional performance conditions are attached to vesting. Performance conditions limit early exercise, as do vesting restrictions, and they (psychologically) reduce the potential payout of the plan from the point of view of the executive.

In the case of relative TSR as performance measure, the fair value of a plan (and thus the company costs) is higher *with* the performance condition than without it, due to progressive payout schemes. It is however unlikely that the executives will be aware of this, and even if they would be, the executive value is still likely to rise less than the company costs, which again increases the plan's inefficiency.

4. Perverse Incentives in the Incentive Plan Design

Our results show that the structure and number of the incentive plans of Dutch companies have significantly changed in the past few years. Designing the optimal incentive plan, however, is not easy since incentives can work both ways. On the one hand, they can encourage the executive to achieve better business results, but on the other hand, ill-designed plans may create perverse incentives, tempting the executive to cheat and game the system, and making him/her focus on the wrong business goals, or reward him/her for luck rather than for good performance.

Most problems with incentive plans stem from a 'horizon problem' (or 'timing problem'). Although this term is mostly used in reference to an increased short-term focus of executives caused by incentive plans (Dechow and Sloan, 1991), this is in fact a problem occurring with all incentive plans with a definite term. Since in all these plans performance is measured at the end of a specified term, it is always at one specific moment in time when the stakes are the highest to achieve the maximum performance. In annual bonus plans this moment is the end of the financial year, in stock option plans this is the end of the exercise period (and if performance conditions are attached to vesting, also the end of the vesting period) and in the case of performance shares this is the end of the performance period. The effects of this horizon problem on the behaviour of executives vary per type of plan and the performance measures adopted (Rappaport, 1978).

One of the main concerns with regard to incentive plans is that they may stimulate executives to focus on the short-term performance of the firm at the expense of its long-term financial health. This problem is in particular related to the annual bonus plan, which evidently has a short term. However, this problem is also caused by a business environment that is increasingly focused on short-term performance, resulting in an increased pressure exerted by the market of corporate control, the managerial labour market and internal control mechanisms (Jensen and Murphy, 2004). Rappaport (1978) even argues that America's preoccupation with short-term financial returns has been an important contributor to the lack of R&D investment and capital spending and the subsequent decline in US companies in the 70s of the previous century.

The performance measures and payout schemes in the typical Dutch bonus plan are in most cases based on measurable and previously determined targets, mostly accounting measures attached to a payout scheme that defines an at target performance, a threshold performance and a maximum bonus. Healy (1985) found evidence that bonus plans create incentives for managers to find accounting procedures and accruals that maximize the value of the bonus plan. Holthausen et al. (1995) also show downward manipulation above the maximum, however not below the threshold. In addition, Gaver et al. (1995) observe that managers do not select income-increasing accruals when earnings fall below the lower bound, and they suggest that this is due to a combination of bonus maximization and income smoothing behaviour. As a solution to this gaming problem, Jensen (2001) has suggested to adopt a fully linear pay-performance system that rewards independently of budget targets. A linear pay-performance relation would remove the 'kinks' out of the bonus line, thereby abolishing the incentives to game the system. On the other hand, this system

might take away any motivational effects of clear targets and could lead to excessive bonus payouts in the case of exceptional performance.

Another issue with respect to equity-based incentive plans is earnings management. Due to the increased value of equity-based compensation as part of the pay package, share price performance has rapidly increased in importance in determining the executive's income. This has led to the perverse incentive whereby executives are encouraged to use their discretion in reporting earnings and accruals to manipulate the share price (Bergstresser and Philippon, 2004). The wish to manipulate share prices is rooted in the need to meet or beat analysts' expectations. Firms that meet or beat analysts' expectations, even if the reported earnings have been achieved by earnings management, enjoy a larger return over the quarter than firms that fail to meet these expectations (Bartov et al., 2002). Earnings management is not a problem restricted to annual bonus plans; it also plays a role in equity-based compensation. According to Jensen (2005), the pressure of analysts and shareholders to meet and beat expectations has, especially during the Internet-hype of the late nineties, led to a situation of overvalued equity, where share prices are higher than their underlying value. The large rises in share prices has worked as managerial heroin on managers, creating even more incentives to push the share prices, which has resulted in a point of no return and, in some examples, even in cases of corporate fraud.

Large packages of stock options have in recent years often been associated with practices of corporate fraud. Executives with a strong incentive to increase firm value, but of the opinion that competitive or other constraints prevent them from doing so, might choose fraud as a means to achieve this goal, especially if they feel that there is not much chance of being caught (Johnson et al, 2004). Johnson et al (2004) found evidence that executives at fraud firms had significant larger equity-based compensation packages than those at a group of similar control firms. Cools (2005) presents the same results in a similar study. Erickson et al. (2006), however, found no evidence that equity incentives are associated with fraud. Therefore caution is advised in concluding that large option grants lead to fraud practices, considering the many cases in which high-powered equity incentives have not resulted in corporate fraud. It is more likely that executives who are susceptible to fraud are so much convinced of their capabilities to increase firm value that they demand large equity packages.

The analysis of Dutch pay packages has shown that companies have adopted a great variety of performance measures. Particular performance measures could, however, lead to a number of problems of which some have already been outlined above. Most issues concern accounting measures, which are inherently short-run measures and therefore increase the horizon problem. Furthermore, these measures are highly susceptible to manipulation by earnings management, although this is also (but more indirectly) the case with market-based measures.

A great deal of criticism has focused on two important measures, namely earnings (profit) and earnings per share (EPS), two of the most frequently adopted measures by Dutch companies. These measures, which are both bottom-line financial results, can in particular be distorted by accounting practices affected by earnings management, and may encourage short-term behaviour (Rappaport, 1978). Overall, it is important to keep the bonus plan simple and clear. The use of multiple performance measures in multiple incentive plans, without specifying the trade-offs between them, leaves managers without any clear perspective (Jensen, 2003).

The increased adoption of equity-based incentive plans, which by definition contain a performance measure, namely share price performance, has augmented the importance of market-based measures in the compensation package. Market-based performance measures have often been described as ideal measures, reflecting the manager's total contribution to firm value or shareholder value. However, this measure also has its limitations, since managers are often not awarded for their actual performance but for general economic market trends and even luck (Bertrand and Mullainathan, 2001). As a result, many companies have added extra performance conditions to their equity-based incentive plans, in some cases EPS, but in most cases TSR. In an attempt to reflect the executive's actual performance, TSR is measured against the TSRs of a group of peer companies. The higher the company ends up in the peer group ranking, the more shares are vested. In this way

the executive is rewarded for his/her actual performance as compared to his/her competitors rather than for favourable market circumstances. This measure, however, also has disadvantages, since both the value of the plan and the chance to achieve a high ranking largely depend on the relative volatility of the share and not on the company's actual performance.

Several other perverse incentives resulting from the increase in equity-based pay exist. For example, Yermack (1997) describes the trend in which positive share price movements caused by favourable news announcements follow shortly after stock options have been awarded, which is consistent with the view that CEOs influence the structure and timing of their executive incentive contracts. In addition, Aboody and Kasznik (2000) argue that executives control the timing of voluntary news announcements about stock option awards. CEOs control the investor's expectations by delaying good news and rushing bad news in order to maximize possible future payouts. These results suggest that executives could benefit from share price increases that are not caused by actual company performance improvements, but by gaming the system.

The exercise of stock options can also involve perverse incentive issues. Carpenter and Remmers (2001) tested whether executives use inside information to exercise their options prior to negative returns, but only found weak evidence. A study conducted by Huddart and Lang (1996) shows that exercise is strongly related to preceding share price performance (which is no problem), but not to subsequent share price performance, which contradicts the evidence for the relationship between cheating and option exercise. Ofek and Yermack (2000) argue that when managers with a high stake of ownership in the firm receive new options, they typically reduce their risk exposure by selling the shares they already own. They also indicate that when managers exercise options to acquire shares, nearly all of the shares are immediately sold, regardless of prior ownership. This finding is of major importance, because it suggests that the prime objectives of equity-based plans, increased incentives and retention, are undermined by executives who sell existing shareholdings. Consequently, the new equity grants would only serve as extra compensation.

To prevent exercise by executives after large share price increases in a relatively short period after the grant, many companies have introduced vesting periods, which prevent early exercise and the subsequent loss of incentives. A recent trend in Dutch long-term incentive plan design is to introduce additional vesting periods after the performance period has lapsed, which prevents exercise (or sale) in some cases for five to eight years. Deferred compensation arrangements have furthermore been created to force executives to invest a minimum portion of their own wealth in company shares.

When considering the perverse incentive effects discussed, one may suggest that managers use the inefficiencies in incentive plans to deliberately optimize their value. Although Dutch incentive plans are susceptible to fraud, it is not clear whether in actual practice this leads to large losses of efficiency. There are, however, strong signals that a number of perverse incentives have been accounted for in the design of new incentive plans, e.g. by including vesting and performance restrictions into the plan, by imposing strict restrictions on the exercise of stock options and by increasing the discretionary power of the supervisory board, which can be considered as a positive development.

5. Conclusions

The agency and risk sharing problems resulting from the separation of control in the modern firm can be mitigated by a number of governance mechanisms, namely the regulatory system, the product and managerial labour market, the market for corporate control and the internal control system, of which executive remuneration is an integral part. Although the Dutch two-tier corporate governance system offers a unique mix of these governance mechanisms, it has been subject to many changes in the past few years. Once characterized by a large degree of managerial entrenchment, an inefficient internal control system and a non-functioning corporate control market, the Dutch corporate governance system is now ranked as one of the best in Europe (EIRIS, 2005). A rapidly globalized business environment and managerial labour market, the breakdown of take-over de-

fences, increased monitoring possibilities due to better information systems and an invasion of Anglo-Saxon investors have led to dramatic shifts in the governance structures. At the same time, the Ahold accounting scandal in the Netherlands triggered the implementation of the Tabaksblat Corporate Governance Code, which has laid down principles on the structure, independence, composition, expertise and remuneration of the executive and supervisory board.

This study has reviewed the Dutch executive remuneration practices in the light of these governance changes and has signalled several trends. The first major trend that could be identified is that in recent years the structure of many incentive plans has been revised and that a renewed attention toward the discretionary powers of the supervisory board has emerged. Under the influence of the Tabaksblat Code and outside investors' pressure, many companies have added performance conditions to option and share plans and made bonus plan measures 'previously determined, measurable and influenceable'. On the other hand, a growing number of companies have made part of the annual bonus payout dependent on the discretionary judgement of the supervisory board. This suggests that supervisory board directors have become more engaged in the pay setting and performance evaluation process. The second major trend is that the value of equity-based pay increased considerably in the period of 2002-2004 and that new forms of long-term incentive arrangements have been introduced. In particular, option plans have been replaced by performance share plans and deferred bonus plans have been added to the pay package. This seems to have been triggered by the negative reputation of stock options, the fact that performance shares are in general reviewed more positively and therefore regarded by the investment community as reliable and legitimate, copycat behaviour, fundamental flaws in the option plan design, the more stable payout that performance shares offer, the compulsory expensing of stock options under IFRS 2, and a changed tax regime. The shift from options to performance shares has resulted in large increases in equity-based pay value and, consequently, in total pay package value. This third trend is in particular triggered by rising share prices, which have affected the value of fixed number grants and increased the preference for a large equity-based component in the pay package because of the strong alignment between manager and shareholder and subsequent incentive effects.

These findings lead to some remarkable conclusions. First of all, new regulations (Tabaksblat Code, IFRS 2) have had a significant effect on the structure of executive pay arrangements. Although not legally binding, most companies have chosen to comply to the principles of the Tabaksblat Code, most likely for reasons of legitimization. However, these principles do not always need to be efficient from an economic point of view. Hall and Murphy (2002) for example, observe that options granted at a discount can increase the incentive effects. In addition, Core et al. (2003) conclude that re-pricing options can be beneficial from an incentive point of view. Hall and Murphy (2002) also argue that long vesting periods, and quite likely also performance conditions, lower the ratio between perceived value by the executive and the company's costs, thereby lowering the incentives. Therefore, one might argue that the principles laid down in the Tabaksblat Code, which limit the abovementioned practices, might not be efficient in an economic sense. Furthermore, the tendency of remuneration committees to attach ever more vesting restrictions to long-term incentive plans, might not be the best way to motivate executives, who are no longer able to distinguish the link between behaviour and payout. The most recent trend in Dutch executive compensation, relative TSR performance share plans might seem an appropriate and responsible way to reward an executive (since companies have to perform better than their competitors). The complexity of such plans, however, might on the other hand also lower the value from the executive's point of view. A trade-off has therefore been established between conforming to 'good' corporate governance and maximizing the potential incentives and subsequent value.

Second, Dutch remuneration committees seem to have unlimited faith in the explanatory power of agency theory. In order to align managerial and shareholder interests, a large equity-based pay package is more and more considered as an essential part of the pay package. Although based on strong theoretical arguments, empirical evidence of a positive pay-performance relationship is at best ambiguous, but in any case not very convincing (e.g. Morck et al., 1988; Himmelberg et al., 1999; Demsetz and Villalonga, 2001; Core and Larcker, 2002). It seems that the optimal level of equity-based pay is above all contingent on a number of manager- and firm-specific factors, of which firm risk and

compensation risk appear to be the most important ones (Eisenhardt, 1989). However, based on psychological research a strong case could also be made for the view that the best way to reward executives might not have to involve variable pay at all, since performance pay may crowd out the intrinsic motivation of the executive (Frey and Osterloh, 2005). In addition, possible perverse incentives resulting from plan design can trigger unwanted behaviour (e.g. Jensen, 2003) and the rewards associated with incentive plans might not be based on actual performance, but merely on luck (Bertrand and Mullainathan, 2001). Overall, in the light of this evidence the remuneration committees' great trust and belief in equity-based pay might be somewhat overdone.

Third, as a result of changes in the governance mechanisms, the disciplinary measures to control the behaviour of executives have considerably increased. Tighter regulatory requirements (Tabaksblat Code), the increased intensity of the corporate control market, a growing competition in the managerial labour market, enhanced monitoring possibilities and a more prominent role of the supervisory board have all had an impact on the effectiveness of control. These disciplinary governance mechanisms should theoretically decrease the necessity to align the interests of executives and shareholders via pay constructions. However, the results of this study show that compensation, and in particular the value of equity-based compensation, has increased anyway. This raises the question whether compensation packages are designed in an optimal way, or merely negotiated at arm's length and if there are other factors that determine the level and composition of the pay package. In this respect, especially the practice of benchmarking seems to have had a significant impact on pay packages. External benchmarking, often based on firm size and complexity, is considered as a necessity in establishing a competitive pay package compared to other companies. This argument has often been put forward by supervisory board directors when large pay increases had to be justified. In an increasingly globalized managerial labour market, Dutch pay arrangements should be competitive with those in the US and the UK, which historically offer a higher total pay and a larger LTI package. If they are not, the executive may leave the company to go elsewhere. In addition, the fact that compensation packages differ per country will demotivate those executives who are relatively underpaid. The benchmarking issue, having a racketing-up effect on pay, in combination with the possible demotivation of underpaid executives, might therefore be one of the major drawbacks of the increase in transparency.

Another explanation for the large seemingly unnecessary increases in pay could be that the mentality of managers is still highly entrenched and that they are in the position to influence the supervisory board members (Bebchuk and Fried, 2004). If this hypothesis is true, it means that the large increases in pay have not been caused by competition or economic considerations, but simply by the objective to increase the executives' total pay. However, if the only objective of increased equity-based pay is to increase total pay, a more effective way would be to increase the fixed pay, since this is risk-free income and therefore valued most. In the current governance climate, however, this would be considered as socially inappropriate.

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Table 1

Population

AEX:	AMX:	Small Cap:
ABN AMRO	Aalberts Industries	Arcadis
Aegon	AM	Athlon Holding
Ahold	ASM International	Ballast Nedam
Akzo Nobel	BAM Groep	Boskalis Westminster
ASML	Corio	Draka Holding
Buhrmann	Corus	Eriks Group
DSM	Crucell	Euronext
Fortis	CSM	Frans Maas Groep
Getronics	Fugro	Gamma Holding
Hagemeyer	Heijmans	Grontmij
Heineken	Laurus	Imtech
ING Groep	LogicaCMG	Kendrion
KPN	Nutreco	Macintosh Retail Group
Numico	Océ	OPG Groep
Philips	Randstad	RSDB
Reed Elsevier	Rodamco Europe	Schuitema
Royal Dutch Shell	Stork	Sligro Food Group
SBM Offshore	Van der Moolen	Stern Groep
TNT	Vastned Retail	Telegraaf
Unilever	Vopak	Ten Cate
Vedior	Wereldhave	TKH Group
Versatel	Wessanen	Univar
VNU		USG People
Wolters Kluwer		Van Lanschot
		Wegener