

**Is there a Negotiation Process in UK Remuneration Committees?**

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## **ABSTRACT**

**Purpose** - The study assesses how closely observed practice in a sample of UK companies accords with theories of managerial incentives when determining director's remuneration.

**Design/methodology/approach** - A qualitative research approach is adopted, based on structured interviews conducted with 15 directors who each serve as chair of at least one remuneration committee.

**Findings** - The observed practice of remuneration committees is found to be difficult to reconcile with principal-agent views of director remuneration. The evidence supports a more institutional perspective.

**Research limitations/implications** - Access constraints to this elite group placed limitations on the sample size, hence, the robustness of the conclusions is qualified. Further studies are needed.

**Practical implications** - Remuneration committees would benefit from self-reflective appraisal of how they handle the negotiation process involved in setting director's remuneration. Effectiveness of the process could be increased if the roles of the various players and the control and flow of market intelligence were to be clarified.

**Social implications** - Increased public understanding of the difficulties confronting remuneration committees, as exposed here, can improve the level of debate that surrounds this emotive topic.

**Originality/value** - The originality of the paper lies in its focus on the negotiation process that is at the heart of director's remuneration. It will prove valuable to all directly involved in the process, and to the many more who are called upon to vote on the DRR at each AGM. It will also interest academics, some of whose theories are challenged by the findings.

**Key words** - Remuneration committee, director pay, principal-agent, negotiation.

**Paper type** - Research paper.

## 1 Introduction

The overwhelming majority of research in the area of executive remuneration has been quantitative in nature (Frydman and Jenter 2010). This is for understandable reasons, as the essence of the subject is an empirical one and data abound. As will be outlined below, however, this quantitative analysis has tended to raise more questions than it has answered. But one thing it has accomplished (Conyon 2011) is to bring into sharp focus the operation of the board subcommittee known as the ‘remuneration committee’ (or ‘compensation committee’ in the USA).

The remuneration committee plays a pivotal role in determining and monitoring the remuneration of the company’s executive directors. Its independence and the transparency of its procedures are viewed as key components in the control of director remuneration (Conyon and Peck 1998). The composition of the remuneration committee is, these days, determined by governance regulations such as the Corporate Governance Code (FRC 2010) in the UK or stock exchange listing rules in the USA (Dodd-Franks 2011; NYSE 2004). Its procedures (ABI 2011, 2009) and transparency (DTI 2002) are carefully regulated and monitored. Yet, concern regarding the efficacy of boardroom remuneration arrangements continues to be expressed. In a recent speech Vince Cable, Secretary of State for Business, Innovation and Skills, declared:

“To be frank, I don’t see much evidence that remuneration committees have been living up to their responsibilities, or that major shareholders have been holding them to account.” Vince Cable (June, 2011)

This perspective is also to be found in a UK government discussion paper (BIS 2011). There is clearly something happening in remuneration committees that is not easily captured by quantitative metrics such as the independence of committee members, the membership or otherwise of the company chairman, the use of remuneration consultants, and so on (Conyon et al. 2009; Gregory-Smith et al. 2009).

It is, therefore, surprising that, to date, there has been only a relatively modest amount of qualitative work examining the inner workings of the remuneration

committee. This paper redresses that deficit by conducting a series of semi-structured interviews with a group of non-executive directors each of whom serves as a remuneration committee chairman. The focus of the study is on the procedures followed by remuneration committees and, in particular, on the nature and context of the negotiation that takes place between the remuneration committee and the top executive team regarding remuneration arrangements (Kakabadse et al. 2004; Schwab and Thomas, 2006). The following section reviews the relevant literature and develops the research questions to be addressed. Section 3 of the paper describes the sample and the interview procedures followed. Results are presented in section 4, and the paper ends with a discussion of the implications for theorising and for policy formation in the area of director's remuneration.

## **2 Perspectives on setting director's pay**

The topic of director's remuneration in large publicly held companies has, over recent years, come to be regarded as a laboratory for testing the various theories of managerial incentives (Conyon et al. 2010). Seen by some as the classic locus of the separation of ownership from control (Berle and Means 1932), principal-agent theory predicts that pay incentives would be deployed to offset difficulties in direct supervision and problems of asymmetric information experienced at the top of large public companies (Jensen and Meckling 1976; Jensen and Murphy 1990).

Initially, econometric studies of director's pay and company performance revealed such a modest connection as to throw these theories into doubt (Jensen and Murphy 1990). However, the rise in the shareholder value movement with its accompanying vigorous use of executive share options and performance shares led to later estimates being somewhat more supportive (Hall and Liebman 1998; Main et al. 1996). Theories were adapted so as to allow for the risk aversion of the directors, and this also helped reconcile the still relatively weak empirical estimates of pay and performance with principal agent theory (Hall and Murphy 2002). Nevertheless, the unavoidable conclusion of both meta studies (Tosi et al. 2000) and literature reviews (Frydman and Jenter 2010) of work in the area is that much remains unexplained when trying to understand the award of director's remuneration.

Rival theories have attempted to offer better explanations. Probably the greatest attention has been given to the views of Bebchuk and Fried (2004) who regard the process as being dominated by managerial power. The independent directors on the board, far from taking charge of the process of crafting pay arrangements to link executive director's pay to performance, are instead seen as being in the power of the executives. The remuneration committee, the board subcommittee charged with deciding the pay arrangements of executives, is portrayed as being captured by the executives to the extent that pay awards are made which bear little relationship to managerial performance, and are essentially a form of 'rent extraction' (Bebchuk et al. 2002). The remuneration committee becomes the puppet of the CEO, hence undermining any notion of what is portrayed as the all important principal-agent 'arms length contracting' between the company and the executive directors (Bebchuk and Fried 2004, p61).

This perception of the CEO and the executive top management team behaving opportunistically (Williamson, et al. 1975) so as to enrich themselves at the expense of shareholders has not gone without challenge (Conyon 2006; Core et al. 2005). Importantly, it is difficult to accept this vision of rampant managerial power as a primary explanation of increasing directors pay when standards of corporate governance have been uniformly increasing over recent years. For example, in the UK a series of investigative committees (Cadbury 1992; Greenbury 1995; Hampel 1998; Higgs 2003) have had their recommendations on corporate governance reforms enforced in what is now known as the '*UK Governance Code*' (FRC 2010). In addition, reporting standards have also been substantially improved, for example, for the UK in the Directors Remuneration Report Regulations (DTI 2002) and for the USA in SEC (2006).

The Bebchuk and Fried (2004) perspective does, of course, focus attention on the activities of the remuneration committee. Their general point regarding the potential for deviation from what principal agent theory might regard as the optimal remuneration arrangements is not implausible. As with the board, the remuneration committee is a social entity and can be expected to be susceptible to subconscious biases in its decision making, owing to the effects of social influence (Zimbardo and

Leippe 1991) and reciprocity (Cialdini 1984). The empirical significance of these effects has been documented for both boards (Westphal and Zajac 1997) and remuneration committees (Fiss 2006; Main et al. 1995; O'Reilly et al. 1988; Wade et al. 1990). The Bebchuk and Fried (2004) argument holds that the CEO cynically exploits such effects with the intent of extracting more generous pay award than is in the shareholders' interests. From the perspective of social influence, on the other hand, deviation from any notion of optimal reward arrangements will arise as a happenchance of the social situation.

The potential for the remuneration committee to deviate from what principal agent theory might see as optimal remuneration arrangements, while all the while actually striving to do the right thing, is also highlighted by neo-institutional theory (Scott 2001). This view sees remuneration committee decision making as being dependent on norms and rules of thumb which become engrained in practice through repeated use. Behaviour is circumscribed by a custom and practice that is 'taken for granted' (DiMaggio and Powell 1991). Faced with complex and emotive decisions on director's pay, the remuneration committee strives for "legitimacy" (DiMaggio and Powell 1983; Meyer and Rowan 1977). This is achieved by variously following the lead of other remuneration committees ('mimetic isomorphism'), or by taking a lead from the prescriptions of outside agencies and shareholder bodies ('coercive isomorphism'), or by members drawing on their individual experiences as professionals in this area ('normative isomorphism'). In each perspective, the pay award has more to do with what others are doing than the circumstances of the individual company or, indeed, the market for executive talent.

Of course, as Core et al. (2005) observe, Bebchuk and Fried (2004) do not directly attack the notion of optimal principal-agent pay design, rather they emphasise the absence of anything resembling what they label 'arms-length contracting':

"Managers use their power to get boards to pay them more than they would receive if there were an arm's-length negotiation." Bebchuk et al., 2002, p1149

The major research questions of this study, therefore, confront the nature of the negotiation process in contemporary remuneration committees.

RQ1: How are the remuneration arrangements of executive directors determined by the remuneration committee?

RQ2: To what extent can the remuneration committee be viewed as conducting arms-length negotiations with the CEO?

In addressing these questions, it is necessary to directly scrutinise of the working of the remuneration committee, and this points to adopting a qualitative rather than quantitative approach.

There have been a considerable number of qualitative studies of boardroom decision making. Some prominent examples include: Kakabadse et al., 2006, 2010; McNulty et al., 2005; Pettigrew, 1992; Pettigrew and McNulty, 1995; Pye, 2002; Roberts et al., 2005; and Stiles and Taylor, 2000. On the other hand, the number focusing on remuneration committee has been relatively modest. A fairly exhaustive list includes: Bender (2003, 2004, 2007); Bender and Moir, 2006; Conyon et al., 2000; Lincoln et al., 2006; Main, 1992, 1993; Main et al., 2008; Ogden and Watson, 2004, 2008; Pepper et al., 2011; and Perkins and Hendry, 2005. Each of these studies provides evidence to suggest that the principal-agent perspective on director pay determination is overly narrow. The preponderance of evidence from these studies suggests that behaviour is strongly driven by the need to seek legitimacy and that, consequently, there is a substantial amount of conformity in remuneration committee practice.

These findings suggest a further research question that merits investigation:

RQ3: To what extent can the remuneration committee be seen to mainly be conforming to institutional pressures?

The next section of the paper describes how the study was conducted to address these questions.

### 3 Method

To shed light on the research questions developed above, the views of those active on remuneration committees were sought. Previous research in this area (Main et al. 2008) has emphasised the key importance of the chair of the remuneration committee and, for this reason, those with current experience as a remuneration committee chair were targeted. The difficulty of gaining access to such a high status group was overcome by utilising the opportunity afforded at executive remuneration briefings held for interested boardroom directors by a large global consulting firm active in the area of executive remuneration. Requests for volunteer participants were made in the Spring of 2011 and the interviews were conducted over the months of May through July of 2011.

Of the 15 remuneration committee chairs interviewed, three were female. The average age was 60, with a range between 52 and 70 years. They currently sit as independent directors on a total of 28 boards (including 13 FTSE100 and seven FTSE250). Of these, they sit on the remuneration committee at 23 (including 11 FTSE100 and six FTSE250). They chair a total of 17 remuneration committees (including 10 FTSE100 and three FTSE250). Given the voluntary nature of participation in these interviews, there exists the possibility of sample selection bias (Heckman 1979), to the effect that the interviewees may feel more than usually secure in the nature of the practices and procedures on the remuneration committees which they chair. And, indeed, the companies concerned have displayed a higher rate of shareholder return over the past three years than the FTSE350 (8% versus 2% per annum), and have grown faster than GDP in terms of sales (2% per annum versus essentially zero growth at constant prices). This needs to be borne in mind when interpreting the findings.

A semi-structured interview format was drawn up by the researchers<sup>1</sup>. This focused on the procedures followed by remuneration committees in deciding

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<sup>1</sup> Available at (line may wrap):  
[http://homepages.ed.ac.uk/mainbg/Files/RemCo\\_interview\\_framework\\_2011.pdf](http://homepages.ed.ac.uk/mainbg/Files/RemCo_interview_framework_2011.pdf)



director's pay arrangements. A realist approach (Cassell and Symons 2004) is adopted whereby responses are regarded as reflecting the actual situation as perceived by the respondent. The alternative social constructionist (Burr 1995) view would interpret responses in the context of the interview situation, wherein the emotionally and politically charged nature of the topic might suggest that responses reflect the politically correct thing to say rather than the reality on the ground. In addition to the career experience of the interviewers in this area (see below), an effort was made to mitigate any such tendency by refraining from tape recording responses. Experience in this area varies. Bender (2003, 2004, 2007), Ogden and Watson (2004), and Pepper et al. (2011) successfully tape recorded their interviews, while Lincoln et al. (2006), Main et al. (2008), and Perkins and Hendry (2005) utilised a note-taker. Respondents in our sample were clear in their preference for a note-taking approach. On all occasions, three researchers were present at the interview, with the person assigned as the note-taker having no other involvement in the interview process. Respondents had been assured of complete confidentiality and each had been sent a copy of the outline interview schedule in advance of the interview.

Interviews were scheduled to last one hour. Ten were conducted on a face-to-face basis and the remaining six used conference telephone facilities. The interviewers were senior consultants in the area of executive remuneration and an academic with some 20 years of experience in the area (Main 1993). At the end of each interview, the transcribed notes were circulated among the interview team for comment amendment and reflection. The final set of transcribed interview notes were placed in a template to allow the research propositions derived earlier to be scrutinised in the context of the collected evidence. This process took place both in face-to-face meetings and by email circulation among the researchers. Initial findings were tested out at a dinner presentation held for all participants. Finally, a draft version of the paper was distributed to all participants for comment.

The size of remuneration committees ranged between three and six (with a mean of 4.6 and a median of 4). For those for whom a comparison could be made (13 of the 15 companies), the average size was little different from the situation in 2003 but there was now greater homogeneity as previously committee size had ranged from two through seven (Chart 1).

A wide range in the frequency of meetings was recorded (between two and 10 over the past year). The median was 6 meeting per year. This had increased from 2003 when for comparable companies the median had been 5 meetings per year. Most, although not all, companies increased their frequency of meetings (Chart 2). The average length of meetings is around 1.75 hours, and the average total time spent in formal remuneration committee meetings during the past year was 10 hours, although the range was quite considerable – from just over two hours through nearly 20 hours.

There was a strong sense that people felt the process was now more demanding of their time. Although, given some past behaviour, that is perhaps no bad thing:

“The previous remuneration committee chair used to have five minute meetings.” [Director 4]

Selection for service on the remuneration committee was seldom conditioned on the experience of the director, with most of the smaller boards adopting the practice of having all independent directors serve on all board sub-committees. Only three of the 15 respondents possessed a background in human resources or remuneration. On larger boards, selection was determined by a combination of availability and a willingness to assume these responsibilities. The remuneration committee is seen as a relatively demanding assignment:

“When comparing an audit chairman with a remco chairman, the latter proves a more onerous experience. Although chairing an audit committee is technically more complex, understanding details of the half-year and full-year results etc., that of a remco chairman comes with a significantly greater level of stress and is hugely emotive. One can really get into debates, e.g. over appropriate disclosure, in the audit committee but you are really sat in the middle at a remco - on the one side with the executives who have personal aspirations towards reward and, on the other, with the shareholders - and you have an obligation to the company. There are a lot of stakeholders involved and, in my experience, issues between executives and shareholders can become extremely contested.” [Director 13]

The semi-structured interview schedule took respondents through the stages that were followed over the course of a year in setting the remuneration arrangements of the

executive directors. The majority of respondents reported that they were responsible for setting the pay of the board level executives and those at one level below. A few had sign-off or oversight of exceptional payments further down the company (e.g., where there was to be early vesting of long term incentives upon leaving). Financial institutions, of course, now have a regulatory responsibility for the bonuses of all code staff (FSA 2010).

The following analysis will concentrate on what most considered to be their main focus of attention, namely the remuneration of the executive directors.

## **4 Research findings**

The Corporate Governance Code (FRC 2010, para.D.2.2) indicates that the remuneration committee should enjoy delegated responsibility for setting the remuneration of all executive directors. Our data reveals that this responsibility is exercised while interacting with several other actors. Figure 1, which attempts to capture these interactions, reveals that in addition to the dyad between the remuneration committee and the CEO, the advisor(s), the company's human resources function, shareholders and their representative bodies, and the Company Chair all play an important part in the process. This presents a complex negotiating environment (Lewicki and Litterer 1985; Pruitt 1981). Each relationship will be examined in turn before some more general observations are made in terms of Bebchuk and Fried's 'arm's length negotiating' and potential improvements in the process.

### **4.1 CEO**

In terms of the formal structuring of interactions, there is a wide variation of approaches to dealings with the CEO, and the executives in general. In only seven out of the 15 focal remuneration committees is it standard practice to meet at arranged times without the CEO being present. Exact arrangements can vary:

“Each remuneration committee starts with a private meeting between committee members, only then is the CEO invited in.” [Director 2].

“The remco meets without the CEO when trying to reach an agreement with them. There were three meetings without them and there are discussions with the executives that are not formal remcos.” [Director 9]

Much less usual is the default option of the CEO not being present unless requested:

“CEO is mostly not present – he is specifically invited when input is needed on the pay and performance of his direct reports.” [Director 11]

Of course, conversation between the remuneration committee members on remuneration issues can take place privately in other venues and by other means:

“There are also a lot of emails and telephone calls between remco members to discuss issues. There is also a non-executive directors dinner four times a year before board meetings, which gives the remco more opportunity to informally discuss issues” [Director 6].

In all cases, the CEO always withdraws when their own pay is being discussed, but there is a universal feeling that engagement with the CEO is vital. Equally important, of course, is the nature and tone of the relationship between the CEO and the remuneration committee. Indeed, this concern regarding the relationship with the CEO conditions the approach to having the CEO present:

“Personally, I think CEOs, except when discussing their salary, don’t want anything done behind closed doors without the knowledge of the executive team.” [Director 10]

While it would be difficult to design acceptable remuneration arrangements without engaging with the CEO, and hence the executive team, practice does seem to vary in the extent to which the process is regarded as a joint problem-solving exercise as opposed to a negotiation (Fisher and Ury 1981). In terms of who takes the initiative in terms of new pay arrangements, it seems to fall to management in half of the 12 companies where responses permit a clear sense to be gained of this. On other occasions the initiative comes from the remuneration committee, but it is seldom seen as coming from advisors.

“Management proposes and the committee reviews. There is a negotiation and executives have considerable initiative in the process.” [Director 8]

“The remuneration committee would not initiate the design of a bonus plan but might challenge and pose questions regarding design.” [Director 12].

“The executives are where the ideas come from but I would not use the word negotiation. ... in the triennial review we would expect to discuss and debate with the CEO and the FD to get their perspective. ... Targets for bonus are proposed by the finance director with supporting logic and debated in the remco. With annual salary increases I am keen to have the CEO propose the change for his reports, to get his logic, and then set his in the context of that.” [Director 13]

It is also clear that relations with management and, indeed, the temperament of management can colour the process and impact on its effectiveness.

“The committee had to deal with perfectly legitimate matters but the CEO and non-executives have become very personal and emotional which is highly unhelpful. If the CEO gets defensive on issues or if one or more of the non-executives feel that it’s an unreasonable request then we are in a very bad place – this really is a very emotional subject.” [Director 2]

“Good decision making can take place when management are calm about things and discussions are not laced with too much emotional baggage, e.g. the view that there will be a massive reduction in commitment or feelings that one change might lead to the top cadre leaving.” [Director 7]

There is also some ambiguity in the perceived role of the remuneration committee as to whether they are negotiating or critiquing proposals – let alone coming up with their own proposals.

“It goes back to trust and transparency. For it to work well, you need common understanding and trust. It can’t work if it ends up as a trade union negotiation. The remco don’t see their role as getting into the detail to come up with a counter. Their role is to critique. You must be conscious of the self interest of the executives. There is always heightened interest when there is anything to do with compensation. You’d be naive to think executives aren’t thinking about what it means for them.” [Director 14]

The make-up of the remuneration committee can also impact on decision making and can anchor or frame the negotiation (Tversky and Kahneman 1974, 1981):

“The remco has a mix of personalities. [Remco member X] is a real hard nut, always adopting an aggressive stance towards payment of reward. [Remco member Y] is was used to getting lots of money himself in his previous job and is slightly on the generous side. The Chairman of the board is very smart about remuneration matters”. [Director 10]

Asked their view as to whether pay drives behaviour in this context, respondents express a range of views. Eight respondents clearly believe that pay drives performance, four are equivocal or qualified in their response, and three reject this view. Awarding these responses respectively ‘1.0’, ‘0.5’ and ‘0.0’, the mean score over the sample was 0.67. This is a less than whole-hearted endorsement of the incentive mechanism.

There are those who have great faith in the incentive effect:

“As soon as it’s in their line of vision, it does change their behaviour. You must be careful how incentives are constructed, the measures must be sensible and you need to be careful with what you are paying for.” [Director 3]

“I completely believe that incentives when rewarded correctly do drive behaviours and have a positive impact.” [Director 15]

Some remain equivocal:

“Yes, but no, but! You’d be naïve to think it doesn’t matter. Equally I don’t think executives get out of bed thinking ‘I’m going to earn X today’. It is a complex set of motives. If there is a problem with pay there’s usually something else wrong. Pay is not about quantum, it’s about relativities. It’s if it is not seen to be fair.” [Director 14]

And, there is some scepticism as to the extensive use of highly leveraged reward arrangements:

“It’s a surrogate testosterone as to how you measure your worth. After a certain amount it is not about the money, it flips to comparative status. So long as the CEO is valued sufficiently highly by the Board and the remco it doesn’t matter if it’s £3.8m or £4.2m. Above a certain point it’s about comparison and status — it’s not really about the money.” [Director 5]

“If executives are paid in the region and they consider it fair, then I don’t think it impacts your performance. People won’t back off the throttle if they’re not paid. They’ll perform. It is more about retaining people.” [Director 6]

When asked about the key parameters in the success of a remuneration committee, some highlight the relationship with the CEO and the top management team:

“For the CEO to work in collaboration and for him to see the remco as an aid, not a barrier.” [Director 6]

“Goodwill from the executives, and them not always trying to cut a deal.” [Director 10]

“Effective engagement with executives.” [Director 11]

“ More generally, the open relationship with the executive management team, particularly both the Group Chief Executive and Chairman, is greatly valued.” [Director 14]

Notwithstanding the empirical evidence that remuneration committees craft different pay arrangements for inside CEO successors versus outsiders (Elsaid et al. 2011), it appears that there is some uncertainty concerning the efficacy of incentive alignment and considerable reticence on the part of the remuneration committee in assuming a lead role in negotiating with the CEO (and hence the executive directors, in general) on the design of remuneration arrangements. We next examine the role of the Company Chair in this process.

#### 4.2 Company Chair

Since the 2006 amendment of the Corporate Governance Code, the Company Chair has been entitled to full membership of the remuneration committee, although not to actually chair the committee. In just under half of the focal remuneration committees (seven out of 15), the Company Chair is not an active member. But, in all but one case, they are in attendance even if not formal members, and their involvement is seen as important,

“Membership brings accountability as well as involvement. The chairman of the company is so heavily involved in issues relating to the success of the management team and people issues, it makes sense to get his opinion and input. Plus his input is very important. If the chairman just attended he’d get all the information but would have no accountability.” [Director 14]

In the one exceptional case, the role of the company chairman as intermediary between the executives and the remuneration committee is explicit and given as the reason the company chair is neither a member of nor in attendance at the remuneration committee:

“There is a sense that the chairman should remain a ‘Court of Appeal’ for remuneration issues.” [Director 11]

But this is unusual, with most companies preferring a more integrated process, fully within the control of the remuneration committee. There is a clear potential here for the Company Chair to exert a disproportionate influence over the committees decisions through an authority effect (Milgram 1974), and even to act as an agent for or representative of the management view, but there are no indications of this in the responses, with remuneration committee chairs generally feeling that the Company Chair brings valuable experience and input to the process.

#### 4.3 Human Resources Director and HR Staff

Respondents reveal that there can be an ambiguity in the role of the human resources team (personified in this discussion as the Human Resources Director, HRD) in terms of who they represent. Whereas the HRD can be and very often is an invaluable source of service and support (Kelly and Gennard 1996) to the remuneration committee, there is also the possibility of their taking over the process and of even acting as an agent on behalf of the executives.

“In the past there’s been an unconscious takeover by the human resources director in preparing remco proposals. There was a tussle.... we have now shifted it from human resources writing and proposing and letting the remco approve, to a joint recommendation with the remco chair steering.” [Director 6]

“HR are very influential – they design, propose and set policy and are involved in the top executive policy. Advisors only take a lead when communications between the remco and HR break down.” [Director 7]

“It’s not a criticism of the individual here but I see the role of the human resources director as very difficult – inevitably the role carries self-interest and continual pressure from management, yet the human resources director must



liaise with advisors and provide objectivity to the remuneration committee.”  
[Director 12]

On occasion, there is explicit recognition of the human resources director as a mediator, and human resources can certainly act as a bridge between the two sides:

“The human resources director acts as a bridge between the executive directors and the remco – ‘joining the middle’ – a natural link, especially important when views are very different on each side of the fence.” [Director 15]

This positioning can, however, create tensions:

“The former CEO saw the remco as a miser who held the purse strings which coloured the relationship with the remco and made the human resources director’s job harder.” [Director 13]

And when the human resource function fails to come up to the mark then it is sorely missed as the heavy lifting then falls to the remuneration committee chair.

“HR’s lack of full participation has been a huge problem. There is always a certain amount of oiling the wheels in these processes and I have been left picking up a large amount of the necessary ground work and preparatory work.” [Director 10]

Just over half of our respondents (eight out of 15) can be read as having a strong human resources involvement in the process, where HR can be seen as taking the lead at certain points – and this creates a tension. Tension arises because the remuneration committee wants a strong human resources director and yet aspires to independence. It is a difficult balancing act, in terms of how far to let them in.

#### 4.4 Advisors

Advisors are appointed by the remuneration committee, as required by the Corporate Governance Code (FRC 2010, p23). However, the flow of information or market data supplied to the parties involved follows different paths in different companies. It can flow directly to the remuneration committee who may then share it with the HRD and management. Alternatively, the HRD may receive the information and channel it to the remuneration committee and to management. This allows the HRD to gate-keep (Lewin 1947) information and to frame (Tversky and Kahneman 1981) the

presentation of that information. A third possibility is that the remuneration committee and management receive their own data, possibly having one advisor for the remuneration committee and one for management:

“Currently we have two types of advisors, one to management and one to the remco. This can create tension or it can create a strange dynamic if the two advisors are different”. [Director 7]

“The advisor should be recruited by the remuneration committee chair and the committee. They should work with the executive team. Things have been a bit loose. There’s been too much responsibility with HR. The executive team think the advisors report to them but I don’t think it should work that way.” [Director 10]

There is generally an effort made to minimise the disruption in such cases:

“The remco has a strong view that there is one advisor who provides all the advice and thus it is not a confrontational process with advisors scoring points from each other. The CEO, however, has asked for input from other advisors – they can provide input but it is important that they are fully informed and briefed by our own advisors.” [Director 13]

There are also clear cases of remuneration committee independence in the area of the flow of market intelligence. But sharing of this information is always seen as important:

“Boards should be run like an open book not a state secret and while there might be appropriate healthy tension between the board and executive directors, and between the remco and executive directors, the advice should be fully visible to all sides.” [Director 15]

Although this is, undoubtedly one of the more difficult issues on which to get a categorical reading, there are 10 of the 15 remuneration committees where the committee seemed to manage to retain effective control over the information flowing into the company. In the remaining five cases, the situation is more diffuse. None of the respondents reports any perceived difficulty regarding advisor independence, but, of course, the flow of information provides opportunities for others to have power over the process (Pfeffer 1992). On the other hand, it is plain that busy outside directors require to have support in analysing and processing the information delivered by advisors.

#### 4.5 Shareholders and Shareholder Representatives

All respondents indicate a desire to report remuneration matters in a clear and transparent manner. It is felt that existing arrangements are about as detailed as one might wish.

“The Remuneration Report has turned into an epic of War and Peace proportions! It’s got ludicrous - what you can and can’t understand. The FTSE 100 are super-well disclosed. The issue is not one of a lack of information, we are scrupulous for testing any changes and communicating them – I struggle to see how we can improve on this.” [Director 15]

The initiative in drafting the Director’s Remuneration Report generally lies with the Company Secretary acting in conjunction with the chair of the remuneration committee. In only four companies did the respondent indicate that the human resources department plays any active role here.

Meetings with key investors are scheduled only when there are substantial plan changes to be discussed or when some controversy has blown up. Meetings with institutional shareholder bodies are more regular events and such encounters are, with a few exceptions, experienced as positive and friendly.

“On the whole their letters are more pointed than their conversations. Generally they are very nice people. They make their points. There isn’t a consistent view from stakeholders and shareholders but you can’t please everybody. You have to do what is right, and not try to be popular.” [Director 6]

One of the exceptional cases reported the experience as:

“ .. banal, pointless, confrontational, an unnecessary diversion from running the business, non-value adding and frustrating.” [Director 9]

Although only one out of the 15 respondents reports regular meetings with shareholders, this is perhaps understandable as this duty is placed upon the Company Chair by the Corporate Governance Code (FRC 2010, p23). Such meetings are more likely when a major revamp of remuneration arrangements is being proposed, or

perhaps when discretion is being exercised to facilitate the award of incentive payments:

All but two respondents indicate that the remuneration committee does, on occasion, exercise discretion – generally in both directions.

“We generally do exercise discretion – particularly for LTI target levels which are very difficult to set and we need to incentivise. Ranges, particularly for the EPS target min and max, are small. Therefore, if we take a view that the company has done well then we might change these. We sometimes refer to ourselves as the ‘goalpost moving committee’ and it’s a regular topic at remcos.” [Director 7]

One of those who rules out discretion explains as follows:

“If you do a good job designing the scheme, then there should be no need to intervene. The shareholders have to go with the rough and smooth, and so should the executives. If they are in it for the long-term, they’ll be all right.” [Director 6]

In particular, discretion is used when designing or altering arrangements with the aim of retaining particular key executives who may be on the point of exiting the company:

“Retention payment – we are involved with lots of one-off discretionary plans.” [Director 4]

Although freedom to contract can be frustrated by institutional pressure:

“When you have, on the one side, very emotional executives who you want to retain but equally want to encourage to stretch performance, and at the same time want to reflect the concerns of shareholders, setting the level of executive reward is becoming increasingly difficult in an UK plc.” [Director 13]

In five out of the 13 companies where we have a response, it is indicated that they do consider how previous awards have turned out when granting current awards.

“Especially if managers are losing heart and think that they are not earning anything. Need to get a balance - if too easy or if they are really disgruntled that others are doing better. Life is unfair, but we do try to adjust within constraints.” [Director 7]

And such discretion often occurs in the context of retention:

“If an executive director is likely to jump ship – will need to take this into account when deciding on levels.” [Director 15]

As might be expected, changes in company strategy or company composition can provoke a review of remuneration arrangements.

“Well, a change to company strategy or any major changes or acquisitions may cause a change in the remuneration arrangements. Strong external forces such as shareholder dissent or regulation can also drive change.” [Director 6]

Some frustration is expressed regarding the constraint institutions impose on remuneration committee behaviour.

“ I feel we are straight-jacketed in the UK. Every year in the business strategy, you could do something with the remuneration package to change how people behave. Pay is very usable, no-one can duck it. It’s a really important driver.” [Director 4]

There is an acute awareness, sometimes expressed in the context of the advisory vote, regarding the extent to which non-executive directors serving on a remuneration committee are exposed to reputational risk (Fama 1980):

“We are quite sensitive to getting it right and being seen to be getting it right. The non-executive directors do this for a living, so one mistake can be detrimental as your reputation is your livelihood.” [Director 3]

“The remco is scared of the vote, and by then it is too late, so I feel that consulting is a much more constructive approach when making decisions. Boards worry a lot about reputation, both of the company and personally. If doing something vanilla, there is no need for the consultation and so the best process is management to propose and remco to review.” [Director 3]

So, while chaffing to break away from the institutional isomorphism in practice or the “iron cage” (DiMaggio and Powell 1983), remuneration committee members also feel constrained to conform by those very institutional pressures.

## 5 Discussion

In answer to RQ1, concerning how the remuneration committee operates, the above discussion has drawn on the extensive comments from the chairs of 15 remuneration committees to paint a complex picture of interactions among several key players. These are detailed in Figure 1 which highlights that, in addition to the focal dyad of the remuneration committee and executive directors, there are other important players in the formulation of director's remuneration arrangements. These include the Company Chair, the Human Resources Director (HRD), the advisors, and the shareholders and their representative bodies.

Many observers criticise the effectiveness and efficiency of the remuneration arrangements in UK boardrooms. In particular instances, these criticisms are often well founded (Pepper et al. 2011). But in trying to understand how such situations arise, it is useful to bear in mind the complexity of the negotiating situation in which the remuneration committee finds itself. In terms of RQ2 posed above, about whether the remuneration committee can be viewed as contracting at arm's length, the answer has to be a resounding 'no'. Using the responses gathered from the interviewed remuneration chairs, Chart 3 attempts to summarise the extent of the arm's length negotiation along the dimensions discussed in detail above. It can be seen that on no dimension does the metric come close to reflecting uniform adoption of this level of objectivity. And there is scant evidence in the material presented above of the constant fine tuning of incentive alignment, as assumed in principal agent theory (Core et al. 2005).

But, this is not an issue that is easily resolved in such a small sample of interviews. Empirical studies (Kole 1997) have claimed to demonstrate that fine tuning does indeed take place. Others, however, have suggested that the negotiation may be more one sided than arm's length (Schwab and Thomas 2006). The evidence presented in this paper suggests that, viewed in a wider context as recommended by Perkins and Hendry (2005), it is difficult to conclude that the remuneration committee

even attempts to define remuneration terms in this manner. Everything revealed above points to remuneration committees who very much wish to involve the executive team in the process of negotiating acceptable remuneration terms – acceptable to both the executives and to the shareholders. In doing this, the process involves the advisors, the HRD, the Company Chair and the shareholders. This results in a complex interaction that cannot be subsumed under an arm’s length contracting label.

Of course, the question arises as to whether the notion of arm’s length contracting and the clinically efficient remuneration committee is even a realistic expectation – or some ‘Platonic Ideal’, in the words of Bender (2011). The reality is that the remuneration committee has to conjure not only with the material implications of remuneration but also with its symbolic (Zajac and Westphal 1995) and psychological aspects (Seeck and Parzefall 2008). From this perspective, it is perhaps less surprising to find that in so many cases the initiative for change in remuneration arrangements comes, in fact, from the executives themselves.

This leads us to the third research question posed above – the extent to which the remuneration committee can be seen to be conforming to institutional pressure, and to be awarding similarly designed incentive plans. In seeking legitimacy, there seems to be a great reliance placed on observing what other people are doing – not only in terms of quantum (benchmarking) but also in terms of design. This leads to an isomorphism of practice:

“Remuneration in UK feels straight-jacketed. The tick box culture in the UK means you do what other people do, but it doesn’t make sense for us. At {previous company}, it was a multi-national company, creating pay from scratch so it was imaginative. I feel it’s trapped in the UK.” [Director 4]

“The remuneration committee is quite sensitive to what other remcos are doing as the members all have experience either in their own companies or on other remcos.” [Director 5]

“We have created conformity driven by the corporate governance guidelines. When we want to create something new, for example, profit share or private equity style plans, it can make it very difficult. Executives are cynical about performance conditions but investors want stretching targets – this means that

we have conformed to a certain type, and the question is do they really incentivise and influence behaviours or are they just expected?” [Director 7]

“We discuss around the table what our other remcos are doing. There is a danger of being sheep, but sometimes it is quite helpful.” [Director 9]

Remuneration committees also tend to treat all executives under the same reward plans rather than crafting individual contracts for each (Walker 2010). In the context of neo-institutionalism (Boon 2009; Scott 2001), there seems to be significant support for this view of conformity. Remuneration committees are acutely aware that their actions are being scrutinised and seek legitimacy by falling into an isomorphism of practice – essentially by following what they see others doing. This is, on occasion, felt to be irksome but is generally accepted as the sensible course of action.

Related to this isomorphism is the perception of being caught in a Prisoner’s Dilemma when it comes to making pay awards, where the dominant strategy is to be generous.

“All senior management gets paid far too much money nowadays. It is completely out of control through peer pressure. No one wishes to suffer first mover disadvantage. I do not think anyone knows how to get it under control. Don’t hold your breath for it stopping. I wish I knew the answer. No one is going to want to be the first company to try and change the world. The climate of public opinion will continue to deteriorate and pay rises will go on increasing.” [Director 10]

It is noteworthy that, although a scholar of considerable note in the field of principal agent theory, Holmstrom (2005) draws on personal first-hand experience as a non-executive director to argue as misguided the basic premise of remuneration committees dealing with their executives on an arm’s length basis, “If we err, we would rather err a bit of the generous side” (Holmstrom 2005, p706). And, of course, as Hahn and Lasfer (2011) point out, the incentives and remuneration of non-executive directors themselves remains an under-studied area.

In terms of policy making in this area, to the degree that remuneration committees are caught in a neo-institutional isomorphism of practice, institutional shareholder bodies are able to exert considerable influence through promulgating



codes of practice (ABI 2011). While not being able to impact on the level of reward, these guidelines play a major role in shaping the design of reward. Innovative ways of rewarding such as the idea of “Career Shares” (Main et al. 2011) that improve long term incentives by requiring that all vested equity awards are held until a period after the director has left the company, can be promulgated in this manner and can address some of the questions recently posed by policy makers (BIS 2011).

The picture of the remuneration committee uncovered above is more complex than many commentators allow. Seldom can such well-intentioned efforts have been expended to produce results that are met with such widespread opprobrium. There is clearly considerable scope for further interview-based work if this important area of corporate governance activity is to be fully understood.

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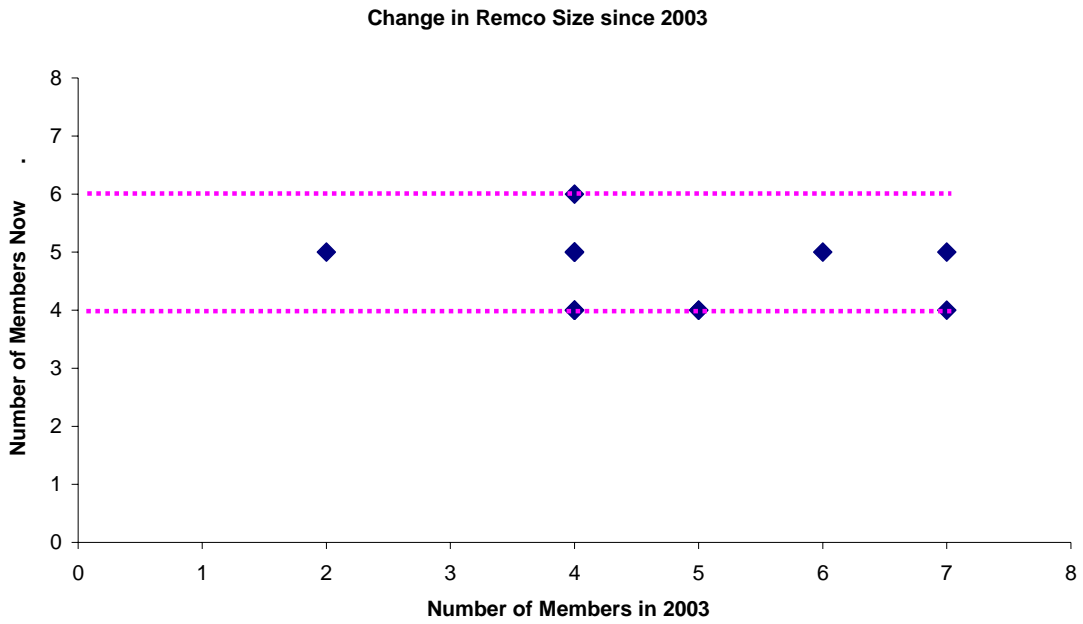
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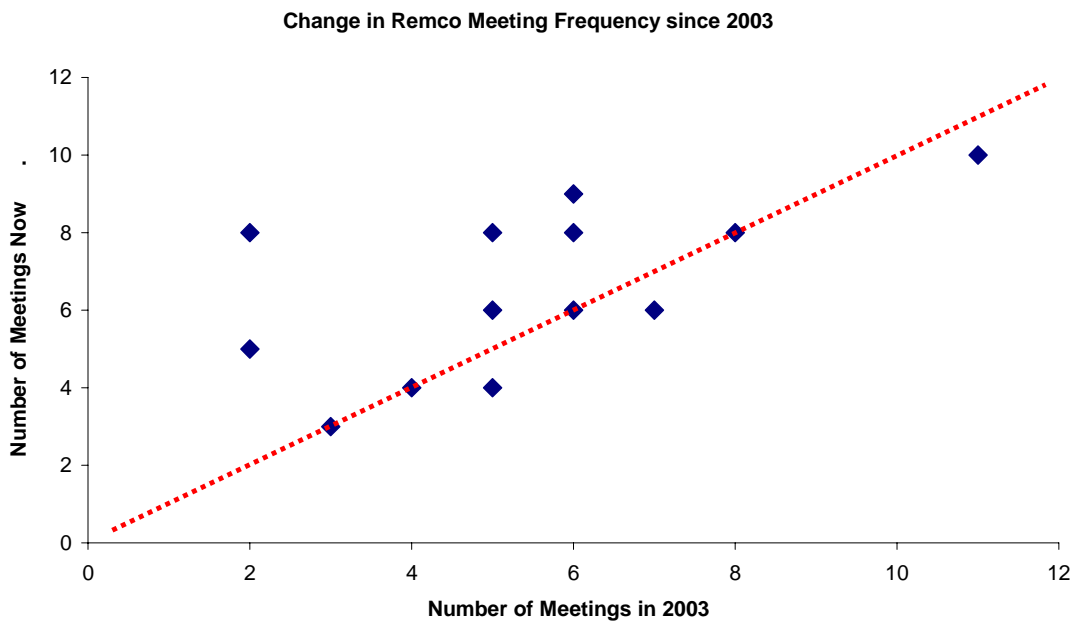


### Chart 1 – Size of Remuneration Committees



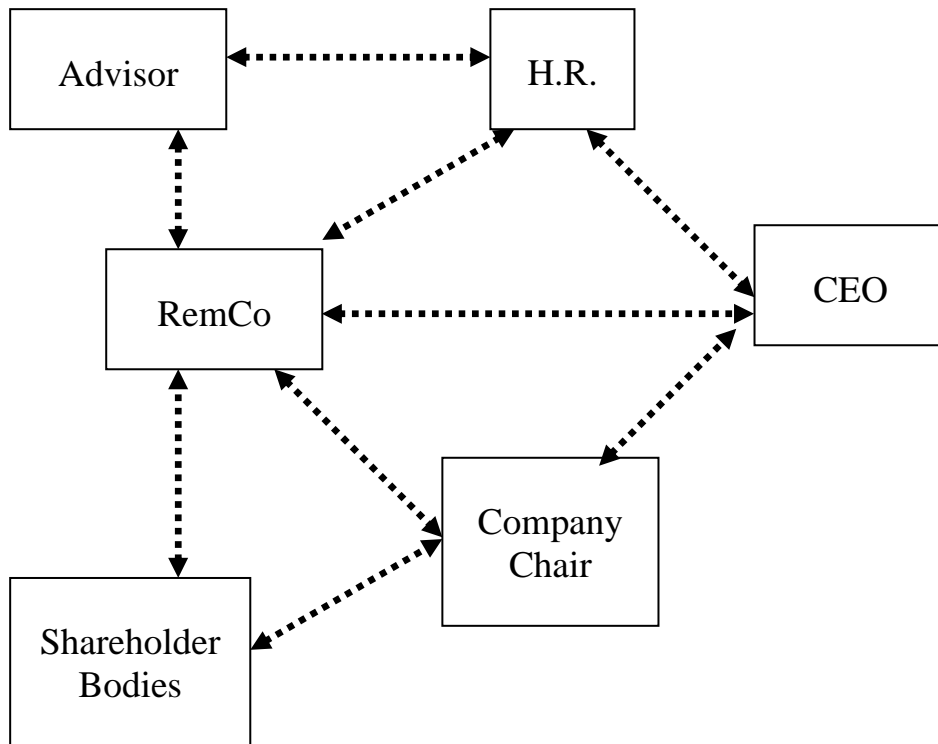
[N= 13 observed in both time periods, some overlap on chart]

### Chart 2 – Frequency of Remuneration Committee Meetings



[N= 13 observed in both time periods]

**Figure 1: The Remuneration committee and its interlocutors**



**Chart 3**  
**Gauging the strength of arm's length negotiation**

