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# How Executive Directors' Remuneration is Determined in Two FTSE 350 Utilities\*

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This paper contributes to the literature on directors' remuneration by reporting the results of interview-based research carried out with executive and non executive directors at two listed UK utilities, and their advisors. The findings on how directors' pay is set reflect aspects of both economic and social-psychological theories. They show that the level and structure of remuneration were clearly influenced by the market, and highlight the problems of determining a suitable comparator market. Institutional theory influences were identified in the level and structure of the pay, and the way in which trends in practices influenced the protagonists. Furthermore, the way in which the companies' policies were tailored to their corporate strategies was consistent with contingency theory.

**Keywords:** Directors' remuneration, executive share options, strategic compensation, labour market

## Introduction

The remuneration of executive directors of listed companies is an area that has attracted wide interest from investors, regulators and the media. Corporate disasters, such as Enron in the United States (US) and Marconi in the United Kingdom (UK), have heightened awareness of the issues arising from the way in which directors are paid. In the UK, it has been the subject of continued regulation: for example, Department of Trade and Industry (2002).

Academic interest in directors' remuneration has also been considerable. Its focus has been on using archival data to establish the relationship between the level of pay and factors such as corporate performance or board composition. Such research has proved conceptually important and added considerably to our understanding of executive remuneration issues. However, the emphasis on archival data has led to research that has

circled around a question of interest both to academics and practitioners: how are executive directors' remuneration policies and packages determined?

This issue has been raised by several researchers over the last two decades. For example, Kerr and Bettis, in a study which examined archival data for a sample of Fortune 500 companies, noted the following:

*It is difficult not to concur with critics who claim that there is no rational basis for the compensation paid to top management . . . research thus far has failed to provide solid evidence to refute the charge. Perhaps what is needed are studies that look closely at the process by which boards make compensation decisions. Most research has attempted to infer the critical variables in the process by examining decision outcomes in relation to performance. As a result, we continue to guess at the inputs to the compensation decision. Given the importance of the topic and of the corporate governance process in*

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*general, it is clear that we must get closer to the process of top management compensation if we are to understand it. (Kerr and Bettis, 1987, p. 661)*

This paper contributes to the executive remuneration literature by presenting findings from an exploratory study which directly addresses the question of how directors' remuneration policies and packages are set. A qualitative methodology was used, interviewing the protagonists in the remuneration-setting process at two listed UK utilities. The research findings suggest that aspects of both economic and social-psychological approaches are relevant in understanding how directors' remuneration is set.

## Background

In the UK, as in many jurisdictions, the remuneration of executive directors is determined by a remuneration committee comprising non-executive directors. The remuneration committee will take advice, as appropriate, both internally and from external consultants (Combined Code, 1998). Although each company will select different remuneration policies and packages, most remuneration contracts for executives tend to be structured so as to include a base salary element and performance-related awards for both annual and long-term performance (PricewaterhouseCoopers, 2000). Researchers investigating directors' remuneration have been interested both in the absolute level of the remuneration, and also in the way in which the different elements are structured.

Previous research has viewed the phenomenon of directors' remuneration through two distinct lenses: economic theories and social-psychological theories. Economic explanations have revolved around the actions of rational man, acting either as a self-serving individual, or as a participant in the labour market. Social-psychological explanations consider the motivations driving the protagonists, and the relationships between them. The following paragraphs expand on these issues insofar as they inform the empirical work reported in this paper.

## Economic theories

Economics is the dominant paradigm in research into executive remuneration, and within this paradigm the most commonly espoused theory is agency theory. Agency theory (Jensen and Meckling, 1976; Eisenhardt, 1989) takes the view that the goals of

directors (agents) and the shareholders who own the company (principals) differ. Directors are assumed to be effort-averse and risk-averse and, if left to their own devices, would run companies to suit their own purposes. Agency theory sees the remuneration contract as one way to ensure that the directors act in the shareholders' interests. Accordingly, contracts are devised which include an element of performance-related pay, with the performance measure(s) being set so as to coincide with the shareholders' needs.

Agency theory reflects the behaviour of man as an individual. Other economic theories use market forces as their explanation of directors' pay. Proponents of labour market theory (Gomez-Mejia and Wiseman, 1997; Finkelstein and Hambrick, 1996) argue that directors' pay can be explained in terms of the supply of and demand for top executives. In this context, Ezzamel and Watson (1998) refer to the need to pay the "going rate" to executives, in order to motivate and retain them.

## Social-psychological theories

In the context of this research, the main social-psychological explanation for the phenomenon of directors' remuneration is institutional theory (DiMaggio and Powell, 1983), which considers the isomorphic pressures that influence companies to act in similar ways. Such pressures may arise due to regulatory influence (coercive isomorphism) or due to imitation of "best practice" (mimetic isomorphism) or be passed on through the professional practices of consultants (normative isomorphism).

Isomorphic pressures may thus provide a coherent explanation for the homogeneity of companies' remuneration practices (New Bridge Street Consultants, 2002a, 2002b). Finkelstein and Hambrick (1996, p. 275) discuss the isomorphic pressures which may lead to similarity in pay structures between companies and, more particularly, within industries. They note that many industries have distinct pay patterns and suggest that isomorphism, in particular, practices passed on by consultants, might be an explanation of this.

Linked closely to institutional theory are theories of legitimacy. Legitimacy relates to the way in which organisations seek to accord with society's expectations in order to gain acceptance. It is defined by Suchman as "a generalized perception or assumption that the actions of an entity are desirable, proper or appropriate within some socially constructed system of norms, beliefs and definitions" (1995, p. 574).

Legitimacy has relevance to directors' remuneration as society's perception of the remuneration may affect the company's status in the domains from which it draws resources. Gomez-Mejia and Wiseman (1997) suggest that one reason companies adopt compensation practices that are widely accepted in their industry is to gain legitimacy. If a company is seen as being over-generous in paying its directors, its reputation may suffer and it may lose valuable support. The use of remuneration consultants can also be seen as a legitimising device, in that they are external to the company, and so their advice is presumably independent (Barkema and Gomez-Mejia, 1998).

Directors' remuneration is determined by remuneration committees, but, obviously, it has an impact on the individuals who are being paid. Proponents of equity theory (Adams, 1963; Miller, 1995) argue that employees consider the ratio of their inputs (how hard they work) to their outputs (how much they get paid) and then compare that ratio to a referent, for example another employee, or an individual in another, similar company. Should they conclude from this comparison that they are treated more or less favourably than others, equity theory asserts that they will respond by raising or lowering their work efforts, in order to re-establish equity.

It is worth considering another theoretical perspective through which directors' remuneration can be considered – decision theory. Decision theory is a broad field and only two aspects of it are discussed here: anchoring-and-adjustment, and bounded rationality.

The anchoring-and-adjustment heuristic (Tversky and Kahneman, 1974) suggests that in many situations people make numerical estimates by starting from an initial value (the anchor), and adjusting this to yield a final answer. Tversky and Kahneman's findings show that the adjustments made are usually insufficient: different starting points yield different estimates, which are biased towards the initial values. The relevance of this to executive remuneration is that remuneration committees often have a figure given to them as a starting point, either previous years' pay, or salary surveys, and their judgement may be influenced by this anchor.

The second aspect of decision theory that appears applicable is bounded rationality (Simon, 1957). This suggests that human beings have limited capacity and cannot obtain, and could not cope with, all the possible information needed in order to take a fully informed decision. Accordingly, they obtain sufficient information to come to a decision, and base their decision on their model of the

world obtained from that limited information. In the context of the remuneration-setting decision, a huge amount of information is potentially available, and it might be that busy individuals "satisfice" their decision by obtaining only part of the available information, and making their decisions based on only part of that.

A further explanation of interest is contingency theory. Proponents of contingency theory (Balkin and Gomez-Mejia, 1987; Barkema and Gomez-Mejia, 1998; Finkelstein and Boyd, 1998) argue that for companies to be effective in realising their intended strategies, there has to be an alignment between the strategy and the company and the environment in which it operates. In terms of remuneration, this suggests that remuneration policies for directors should reflect the company's overall strategy. If they do not, the lack of fit is likely to impede the effective implementation of strategy.

The various theories discussed above have no common thread other than the fact that each has been used in previous research to explain one or more aspects of directors' remuneration. The findings reported in this paper suggest that none of the theories on its own provides sufficient explanation of the phenomenon, but that together they might begin to explain how remuneration committees determine the pay of their executive directors.

## Research methodology

The aim of the research is to investigate the factors influencing remuneration committees in the way in which they set directors' remuneration. Specifically, this paper examines contextual factors that impact on the remuneration, the choice of schemes, and the influence of the market. To do this, this research takes a qualitative approach, a novel methodology in the area of research into directors' remuneration, as most previous studies have analysed archival data (Tosi *et al.*, 2000). As an exploratory study into a process, the use of case studies is an appropriate methodology to adopt for the research (Harris and Ogbonna, 2002; Bonoma, 1985).

The two companies forming the case studies are both utilities (in the electricity, gas, water or telecoms sectors of the market), quoted in the FTSE 350. In considering directors' remuneration in the UK, utilities have an interesting place in history. It was primarily the generous packages awarded to the directors of the newly-privatised utilities that led to adverse public and government attention that

ultimately resulted in the setting up of the Greenbury Committee, which produced its influential report on directors' remuneration in 1995.<sup>1</sup> Utilities were the perceived home of the original "fat cats", although much has changed in the sector since that time.

A second reason for choosing utilities as the context for the case studies is that profits in that sector are heavily influenced by a regulator (Ofgem, Ofwat, Oftel), who makes a regulatory review at five-yearly intervals and effectively wipes out the companies' profit potential in their regulated businesses, re-setting prices at a level which is intended to be sufficient only to cover the cost of capital (Ofwat, 2002). As at least part of remuneration is linked to profit in the majority of companies (New Bridge Street Consultants, 2002b), the way in which companies structure their remuneration to adapt to this constraint is also of interest.

Because of the impact of the regulator on profits, utilities in the UK often choose to expand their activities beyond those within the regulator's remit. This may be done by diversifying into related businesses, or by expanding their geographic reach. Individual utilities have adopted very different business strategies in this respect.

The data source for identifying sample companies was the PricewaterhouseCoopers Corporate CD Register. The initial searches were made on the database dated June 2001. In total, 15 utilities were identified. The two companies for the pilot studies were selected from these. Both were "cold called" in December 2001 to determine their interest in the study, and both agreed to participate.<sup>2</sup>

The companies were originally selected because some or all of their non-executive directors sat on the remuneration committees of other listed companies. It was felt that interviewing individuals with experience of different contexts would add to the richness of the data, and this indeed proved correct. Both of the non-executive directors interviewed sat on several boards, and during the interviews they brought experience from those other boards and contrasted it with the situation in the case study companies.<sup>3</sup> The remuneration consultants also were asked to compare their experience in the case study companies with their experience in other companies, as were the chairmen and those executives who had outside experience.

Coincidentally, there were other similarities between the companies, which proved valuable for the research. In each of the companies, there had been no award made under the long-term remuneration plan for a period of several years. Further (and related in part to

the previous point), each of the companies had changed its long-term remuneration plan significantly in the previous three years, and had changed its annual bonus plan slightly in that period. Finally, each of the companies had changed its remuneration consultants within the last two years.<sup>4</sup> Discussion of these changes presented a useful focus for the interviews, and provided an excellent source of information about the processes.

In each company, semi-structured interviews were carried out with the following people involved in the remuneration-setting process:

- chairman of the remuneration committee ("Chairman"<sup>5</sup>);
- another remuneration committee member ("NXD");
- human resources director ("HR");
- chief executive officer ("CEO"); and
- remuneration consultant employed by the company ("Consultant").

In Utility 1, the compensation and benefits manager ("Comp") was also interviewed.

The interviews were conducted between the end of December 2001 and May 2002. Each lasted between approximately 30 and 75 minutes (with the CEOs being able to spare the least amount of time), and took place at the various offices of the individuals being interviewed. The interviews were semi-structured, in that a broad interview brief had been prepared. However, being exploratory in nature, the discussions ranged widely around those questions. Further, as Hill (1995) noted, in interviewing people of status the balance of power, normally with the interviewer, is with the interviewee. Accordingly, the conversations were often very discursive, although the core elements of the interview brief were always covered.

All of the interviews except one were taped and transcribed. In addition, extensive notes were taken during the interviews, and were written up as soon as practical after each interview. Transcripts have been reviewed by the interviewees, who made some minor amendments, none of which changed the substance of the transcript.

Coding of the transcripts is underway, and is being facilitated using Nvivo. Data coding commenced with the researcher drawing up a preliminary list of possible codes, based on a review of the literature. As the coding progressed, this list was altered and extended to include "in vivo" codes.

In addition to interviews, data were gathered about the case organisations and their institutional environments from the following sources: the latest annual report and accounts



and the one for the prior year; internal documentation (where available); scheme documentation for each company; remuneration consultants' reports for each company; and analysts' reports on the companies.

## Key findings

The findings reported in this paper focus on the strategic issues faced in setting the executive directors' remuneration and, in particular, on the considerations taken into account in making the changes, mentioned above, to their remuneration policies. The following issues are addressed:

- the link between corporate strategy and remuneration policies;
- the choice of the form of the long-term remuneration scheme;
- the use of market comparators; and
- the influence of history.

### *The link between corporate strategy and remuneration policies*

As stated earlier, both of the case study companies had changed their remuneration policies in recent years. From the interviews in both companies, this appeared to be for the same two reasons: human resources (HR) explanations and strategic explanations.

#### *HR reasons*

One of the reasons for the change was the fact that the executives had not received a payout from the long-term schemes for several years. This was seen as a motivational issue. Interviewees put the argument that pay is meant to "attract, retain and motivate" (Greenbury, 1995: section 1.10) and human resource management issues were a key part of remuneration strategy. A scheme that had not paid out, and showed little chance of paying out, was seen as being a poor motivator, and as possibly failing to retain good directors.

*And if you were in a plan where [there] was no possibility of payment even if you were just below median, then the view was taken that this isn't working as an incentive or a handcuff, and it is demotivating. (Consultant 2)*

*Then the message is coming through loud and clear that they have the long-term incentive that is not incentivising. So when you then get a response from the executives which is reinforcing those sort of messages, you don't have to be a rocket scientist to work out that you need to do something. (Comp 1)*

During the interviews, I put forward an agency theory argument that the schemes had not paid out because performance had been less than required, and so the participants should not really expect to receive a payment that was not deserved. The response to this was that although that is what the logic of the situation might demand, it was felt that the individuals still needed to be motivated and retained, and that the pay award was a way to do this. HR 2 explained it as follows:

*Really, it [the long-term scheme] fell into disrepute as a means of remunerating people, because it did not pay out for two, and then three years. People just looked at it negatively. The fact that the company had not performed even at median level when compared with its peers in terms of total shareholder return was not something that they were focusing on. (HR 2)*

In response to the same point, about payment not being deserved, NXD 2 responded in the context of another company with which he was connected, in which the executive share options were underwater:<sup>6</sup>

*Oh, that is an argument that is put, but I don't think that it carries you very much further forward. You could say that they've gone so far underwater that the management doesn't deserve it. You could say that the management should therefore be sacked, you should find a new management. And there is a bit of that, I'm sure. But every day is the first day of the rest of our lives. (NXD 2)*

The thrust of his argument was that having got into that situation, the management needed to be encouraged to bring the company out of it. This view was reflected by several of the interviewees, although views on how to address the issue, for example by repricing options, were polarised, with some interviewees in favour, and most very much against.

Views such as those expressed by NXD 2 would seem to conflict with the traditional view of performance related pay set out by proponents of agency theory. Paying the executives despite their not achieving performance targets conflicts with the agency view of using remuneration to encourage them to act in accordance with shareholders' wishes as expressed in the remuneration contract: the sanction of performance-related pay is diminished if the executives are reasonably confident that incentives will be reinstated regardless of performance.

#### *Strategic reasons*

The other reason given for changing the long-term incentive schemes was that both compa-

nies had changed their corporate strategy in recent years, and it was felt that the remuneration policy had to be amended in order to support the change in corporate strategy.

This link of remuneration with strategy was substantiated by the fact that the two companies, apparently facing a similar, heavily regulated environment, had chosen very different remuneration policies. Each had the traditional components of salary, short-term and long-term performance-related elements, but the way they configured these components was very different. At first sight this made little sense, but during the course of the interviews the very different strategic aims they were following (for example, their different approaches towards diversification) became apparent, and it was clear how the chosen remuneration schemes fitted in with these strategies.

Consultant 1 explained the change in scheme for Utility 1 in these terms:

*The output of the process, the committee felt, and I wouldn't disagree with it, was that the new arrangements better suited the company's then-current structure and focus. They went through what I think is a fairly typical process. They deliberated fairly long and hard on the needs of the business first of all. (Consultant 1)*

HR 1 explained that considerable thought had gone into devising an appropriate remuneration strategy. He pointed out that the core business, being a utility, was relatively risk-free compared to, say, running a dot.com, and so the remuneration packages had to reflect that. However, he noted that the risk was much higher in some of the group's unregulated activities, and this part of the business merited a different reward structure. He explained that at the very top of the business (the focus of this research), the collective responsibility of the board meant that board executives' pay was not highly differentiated to reflect these different businesses; but at the levels immediately below the board the situation was different:

*Underneath the top people, there's quite a degree of variety. We've changed every remuneration policy in the group over the last two years. Every single one. And that's to reflect the diversity of the markets we work in. (HR 1)*

In Utility 2, it was also clear that the group's strategy had a clear impact on the remuneration policies adopted:

*That's the strategic intent . . . and so that too was part of the decision-making process, to ensure that the new arrangements took account of the new strategic intent. (HR 2)*

And

*There was a recognition among the executive that if we were going to change direction, then remuneration had to be reviewed as part of that change of direction. (HR 2)*

HR 2 went on to explain how the company's business would develop further over the next two to three years, as the strategy was gradually realised. He suggested that the remuneration strategy would have to be adapted further at that time, better to reflect these new circumstances.

In both companies the type of scheme chosen and the performance measures adopted were designed to focus the actions of the directors, and to send clear signals throughout the organisation as to what was expected from the new strategy. As discussed earlier, proponents of contingency theory suggest that there needs to be alignment between a company's strategy and its remuneration policies. Balkin and Gomez-Mejia (1987) take the view that effectiveness at realising intended strategies depends significantly on the existence of a match among strategy, organisation and environment. This view was borne out in the sentiments expressed in the interviews, and the intent in the two companies to tailor their remuneration strategies to suit the corporate context.

### ***The choice of the form of the long-term remuneration scheme***

As explained earlier, a standard executive remuneration package in the UK will include an element of variable pay based on long-term performance. Accordingly to Langley (1997) that long-term incentive has three aims: to reward executives, to retain them and to reinforce company strategy. In practice, long-term incentive schemes tend to fall into two types: executive share option schemes, and other schemes, known generically as long-term incentive plans, or ltip (New Bridge Street Consultants, 2002a). Within the constraints of their strategic imperatives, companies have to determine whether to adopt an option scheme, an ltip, or both.

An executive share option scheme awards the executive a number of call options on the shares of the company, which can be exercised during some future period, normally between three and ten years after the grant date. Common practice in the UK is that the exercise price of the options will be the same as the share price at the date of grant. It is also customary in the UK for executive share options to be exercisable only on the achievement of a performance condition, often growth in

earnings per share (eps) over the period (New Bridge Street Consultants, 2002a).

Ltips may take a variety of forms. Generally, there will be an immediate award of shares to the executive; however, these shares will not vest until some time in the future, provided that certain performance conditions have been met. A majority of UK companies using ltips use comparative total shareholder return (TSR) as their performance condition (New Bridge Street Consultants, 2002a). This measures the company's percentage return to shareholders over the period (share price changes plus dividends) compared to that in a comparator group; the ultimate level of vesting depends on how highly ranked the company is in relation to its comparator group.

The literature on executive remuneration clearly sets out the advantages and disadvantages of share option schemes as opposed to other types of long-term performance incentive. For example, Hall (1997) points out the advantages of options, whereas Yermack (1997) illustrates some of their problems. Bender and Porter (2001) discuss the different features of the various plans, and conclude that there is no one correct answer to suit all circumstances.

Outside the academic arena, survey evidence indicates trends in remuneration schemes in FTSE 350 companies that have moved from the use of options to ltips and back to options (New Bridge Street Consultants, 2002a). Institutional theory might provide one explanation for this trend. The move from options to ltips in the mid-1990s followed the Myners report (1995) and the Greenbury report (1995), both of which pointed out the flaws in share option schemes. This perhaps reflects coercive isomorphism. However, companies have found ltips very complex (PIRC, 1998; Pricewaterhouse Coopers, 2001), and a trickle of companies changing back to an option for good practical reasons has become a steady flow as others follow, a mimetic trend. Such an institutional theory hypothesis is supported by comments of one of the consultants:

*... option schemes amongst public companies are now back in favour, as it were. (Consultant)*

The remark that options are "in favour" suggests that there was no clear logical reason for adopting this form of incentive (and this was borne out in the rest of that discussion), but that the remuneration committee was merely adopting a scheme similar to its peers.

In practice, both remuneration committees appear to have followed their individual preferences (or the preferences of their dominant

members – this could not be determined) in deciding which type of scheme to adopt.

*So there are pros and cons [between options and ltips]. But I think it is fair to say that the members of the remuneration committee all favour options. (CEO)*

*We come to personal wishes. ... I think there was a general feeling amongst the non-exec members of the board that share options were not the flavour of the moment. (NXD)*

I queried this NXD on his comment about options not being the flavour of the month, since, as mentioned above, surveys seem to show that they are becoming more popular again. He said that the matter had not been subject to great debate, and that the committee members had felt it more appropriate to go for something that demanded a higher hurdle rate than options normally have.

This raises another interesting point, regarding the performance measures used in options and ltips. As stated earlier, it is common for share options to use a performance measure based on growth in eps, and ltips to use a performance measure based on TSR. However, there is nothing intrinsic to either scheme which states that these measures *must* be used, and indeed there are many examples of companies doing differently. Nevertheless, the comments of this NXD, and those of the consultant who advised that committee, clearly show that one reason why the ltip was adopted in preference to an option was that TSR was seen to be a more appropriate target than eps. In the other utility, which implemented an option scheme with an eps target, the Chairman made the following comment when asked why the scheme was chosen:

*It is a matter of philosophy, isn't it. Both in terms of your view on what the most appropriate performance indicator is – is it total shareholder return or eps? – and we could sit here for the next two days arguing about it and not come to a conclusion. (Chairman)*

Again, his reply to a question about the choice of an option versus an ltip revolved around the use of eps growth versus TSR.

In this context it is worth pointing out that the use of eps growth as a performance measure is fraught with difficulties for regulated utilities, whose profits are reduced by the periodic review every five years. Companies implementing such a scheme have to ensure that it is acceptable to the executives whose retention and motivation it is designed to encourage.

Finally, it was also worthy of note that one of the non-executives interviewed served in an



executive capacity in another company, in a very different industry, whose long-term scheme was very similar to that introduced into the utility. I suggested to him that perhaps the similarity of the schemes had been under his influence. He pointed out that the two companies share a remuneration consultant, and suggested that perhaps that was the other obvious place to look as regards similarities in schemes. This could be an example of normative isomorphism.

### *The use of market comparators*

Companies tend to set their executive remuneration in line with "the market". As well as the obvious connection to labour market theory, this could have two social-psychological explanations. By using market rates the companies can be seen to be satisfying their executives that they are being fairly treated (an equity theory explanation) and legitimising their remuneration in the eyes of stakeholders. In this section, the two main forms of market comparator – for salary and for TSR – are discussed.

#### *Paying the "market rate" for salaries*

In both of the companies, the consultants had prepared detailed reports that were used to benchmark the executives' pay against comparators, and in both cases these reflected three sets of comparators: companies in the specific utilities sector, companies in their FTSE index and companies whose businesses reflected the non-regulated businesses of the case study companies. These three sets of benchmarks were available for each top executive position, giving a lot of data on which the decision could be based. This use of market benchmarks suggests that the economists' concept of paying wages to reflect the marginal contribution of an individual (as discussed by Finkelstein and Boyd, 1998) has no direct place in the practice of setting directors' remuneration, and that the practice of paying "the market" is institutionalised, perhaps reflecting labour market theory.

An interesting finding of the research was that although all of the participants stated that their remuneration was driven by "the market", they could not clarify exactly what "the market" was or how it worked. Answers to questions about exactly what drove either the level of pay or the detail of its structure (for example, how many options were to be awarded each year, what level of bonus should be available) inevitably cited market practice. However, over time, market practices have changed, both in terms of the amounts

paid and in the way schemes have been structured (New Bridge Street Consultants, 2002a, 2002b). Logically, something must have caused that change. However, questions about "what drives the market" or "who is the market" tended to be deflected into answers about the specific market comparators that the companies used at that time.

This bears out comments made by Barkema and Gomez-Mejia:

*An important concern in this regard is how to define the market. The relevant market is an abstraction that exists in people's mind. . . . When a firm decides to pay executives the going rate in the CEO market, it must first decide on the appropriate "comparison others" in the market. Making this choice is a social and political process that may not be subject to explanation on economic grounds. (Barkema and Gomez-Mejia, 1998: 141)*

Such views were echoed by one of the interviewees:

*And we use the term "labour market" generally as if there was such a thing as a labour market. Truly, the definition or the terminology "labour market" is shorthand for a plethora of different markets. (Consultant 1)*

And later in the same discussion, he expanded upon this line of thought:

*Firstly let us identify what we mean by market practice. We use the phrase too carefully. We assume that there is one market position, let's take job X, that there is a market position for base salary, there's a market position for bonus opportunity, and there's a market position for either option grants or real share award scheme awards. There isn't. (Consultant 1)*

He went on to explain that typically in a market there will be a range of plus or minus 20 per cent or 25 per cent between quartiles. Furthermore, it was explained in the same context by Comp 1 that even if a company is adopting a "median" remuneration policy, most will flex at more than plus or minus 10 per cent from that figure. Nevertheless, "the market" is used as the benchmark to determine executive remuneration and the levels of bonus and long-term award. During the course of this line of questioning, comments such as the following were typical:

*Well, looking at their competitors I couldn't see that it was driven by market practice. (Consultant 2)*

The above comment was in answer to a question as to why the company had not adopted a particular alternative policy, and it is that alternative policy which was not market



practice – the policy actually adopted was seen as market practice. And in the course of the same conversation, in answer to a question on why he had said that a particular level of bonus cap was “not generous” he replied:

*You can only measure these things relative to other companies. It's very difficult question to answer. (Consultant 2)*

Consultant 1 took a very philosophical approach to the discussions:

*Because there are no absolute rights. I mean, there is no such thing as overpaying, or underpaying executives as an absolute; there is only overpaying or underpaying based on some comparative judgement. And we all bring different forms of comparative judgement. (Consultant 1)*

The quotations above all cite consultants because they provided the fullest description of this process, and because they are the ones making recommendations to the remuneration committee. However, all of the respondents made similar comments.

The processes reported here can be linked to theory in many ways. The first and most obvious is the connection to labour market theory. Ezzamel and Watson (1998) refer to the need to pay “the going rate” to executives in order to motivate and retain them, and one purpose of the consultants’ reports is clearly to identify what this going rate might be. Secondly, in line with the comment by Barkema and Gomez-Mejia, quoted above, the decision as to which market to use is not obvious, as illustrated by the consultants’ apparent need to provide three separate sets of figures to each company. Finally, the findings also support Finkelstein and Hambrick (1996) in their comments about isomorphic pressures influencing industry-wide remuneration levels.

It is also worth considering the process in terms of two aspects of decision theory – the anchoring heuristic and bounded rationality. As regards bounded rationality, it seems self-evident that the remuneration committees did not seek all possible information on the subject (for example, they only sought the detailed views of one firm of consultants; they only looked at three sets of comparators). Furthermore, the interviewees indicated that the HR professionals prepared and collated a great amount of information, of which only summaries, in accordance with normal commercial practice, were given to the committees. Accordingly, it seems reasonable to assume that a satisficing decision was made.

It also seems reasonable to assume that the anchoring heuristic influenced the decisions. It was not possible to determine precisely how the remuneration committees determined the

exact number for directors’ remuneration; to do that, it would have been necessary to sit in at the relevant meetings. However, on the basis that the final remuneration figures were of a similar size to the figures produced by the consultants, it would be reasonable to assume that the consultants’ reports had anchored the committees’ judgement. It would also seem likely that the remuneration in previous years also acted as an anchor in each company. Indeed, that was borne out by one of the HR directors, who described the pay regime earlier in the company’s history as “... everybody gets inflation. Full stop”. This regime had led after a few years to salaries at the company being out of line with the market, and dissatisfaction by the executives had been one factor leading to realignment with market levels.

A final link to theory relates to the use of consultants to produce the market data. As stated earlier, companies need their remuneration practices to be seen to be legitimate in the constituencies on which they rely. One way to demonstrate legitimacy is to rely on external providers, who are presumably independent. The consultants’ part in legitimising the actions of the remuneration committee is noted by Barkema and Gomez-Mejia (1998, p. 141) who refer to remuneration decisions “involving judgements of the committee members, legitimized by the opinions of external consultants”. This was illustrated in various ways by the interviewees:

*But I do think, there is no doubt that part of this process is a covering of the back. It allows the board to say that it has consulted with consultants. (NXD 2)*

*We chose, in the interests of self-preservation, to rely heavily on the external advice ... (HR 1)*

#### *Determining suitable comparators for TSR*

The issue of choosing comparator companies features in two places in the remuneration decision. As discussed above, the “market rate” means that an appropriate market needs to be selected. Also, most firms use comparative TSR (total shareholder return) over a period as the performance benchmark, which means that comparator companies need to be selected against whom it is reasonable to compare performance.

For both of the case study companies, there was a problem in choosing comparator companies. Part of this problem was a very practical one: as utilities, one obvious comparator group is other utilities. However, over the last three years, the number of utilities listed on the London Stock Exchange has fallen consid-

erably, due to takeovers and mergers. As the utility pool becomes smaller, it is more difficult to use these companies as comparators. This was expressed by Consultant 2:

*Let's say you start off with ten companies in a comparator group. Within six months a couple of them have been taken over. You then get down to three or four. Now, how do you measure median and upper decile with three or four comparators? It just becomes meaningless. What happens if you have a takeover or a merger? Do the schemes pay out, or do you measure up to the date of the takeover? A lot of them pay out in full, and that's given rise to a lot of problems. (Consultant 2)*

On that same point, Comp 1 pointed out that if weaker companies have been taken over, such takeovers are likely to have been at a premium to their share prices, thus raising the return to their shareholders. He asked, rhetorically, if it was equitable that these artificially high returns should be the benchmark against which the continuing companies are judged. This could be seen as a link back to equity theory (Adams, 1963), in that the executives need to believe that they are being paid fairly, and in line with the pay of their peers.

### *The influence of history*

Remuneration policies are not set in a vacuum, and one source of the influences which impact a company's choice of policies may be the events of its past (Gomez-Mejia, 1994, p. 206). As mentioned earlier, the history of directors' remuneration in UK utilities is one of "fat cat" jibes and governmental disapprobation. Despite the fact that the event which set off much of this debate, the 75 per cent pay increase awarded to Cedric Brown at British Gas, took place in 1994 (*Sunday Times*, 11 May 1995), evidence of their effects was clear in both case study companies. This came through in the need to legitimise the company's remuneration policies, for example by using consultants, and in the types of packages set.

*I think that one is also a bit sensitive of the background here as a privatised utility. . . . so they would come under more scrutiny . . . you've got to take that into account. (Consultant 2)*

*. . . had gone through a period of . . . being in the public eye with a focus on pay. So that has an impact. You have a historical impact. There's a reaction. (Consultant 1)*

*There is history in all of this. You can't detach the way the people are paid from the cultural background of the business. (CEO 1)*

*There's quite a lot of history to this, it does go back to the days of the fat cattery. . . . There was a very kind of matter of fact recognition that pay restraint was the order of the day. (HR 1)*

The influence of history could also be seen in the example cited above of salary levels in one of the companies being limited to inflationary rises. In discussions with the directors, it became clear that this too was in reaction to adverse publicity received in the days of the "fat cats". Even though none of the current remuneration committee had been associated with the company at that time, corporate memory appeared to live on, evidenced in the need to legitimise the company's remuneration policies.

### **Discussion and conclusions**

The main concern of this paper has been to put forward a preliminary analysis of the qualitative empirical research into how the remuneration of executive directors is determined. Data gathered in 11 interviews at two case study companies have been analysed to determine the reasons that the companies changed their remuneration policies and the strategic factors they considered in making those changes.

One important outcome of the research is that it demonstrates that the remuneration policies were devised in the context of the company. This was shown in two ways. The choice of corporate strategy had a clear influence on the remuneration policies selected, as the remuneration committee and its advisors tried to align the remuneration policies with the strategic imperatives of the company. The fact that two superficially similar companies ended up with two very different remuneration policies, based on their strategies, demonstrates this. Furthermore, the impact of the companies' history on their choice of remuneration levels and policies can also be seen as a contextual issue.

A significant debate in the field of directors' remuneration is between the relative advantages and disadvantages of executive share options and other long-term incentive plans. This research offers some understanding of how companies choose between the two. It has shown that companies are aware of the features of each, but that in the case study companies the decision as to which to use was taken in part based on the individual preferences of the remuneration committee members. An institutional theory approach was also influential here, in two ways. Firstly, in the comments made about adopting

particular schemes because that is what others were doing; and secondly in the arguments which seemed to equate the type of scheme (options, ltip) with the most common performance measure associated therewith (eps growth, TSR).

Companies adopt different types of scheme at least in part because they follow what other companies are doing. The influence of other companies is also shown in the level of pay that is selected – which is generally based on “the market”. The research shows that there are two separate “markets” used by companies in setting remuneration. In determining an appropriate level of salaries, companies refer to a market comprising companies in the same sector, or in the same FTSE grouping, and use salary data from these comparators in order to establish where their own salaries should lie. A separate market, much smaller, is used to establish comparators for determining how well the company has done in TSR terms when evaluating awards for the ltip. In both cases, the protagonists appreciate the limitations of the market they have used.

Finally, the limitations of this study must be acknowledged. It is a small study, with only 11 interviews conducted in two companies. Further interviews in more companies need to be undertaken, and indeed this work is currently underway. Having said that, it is worth noting that, as well as the remuneration consultants, who obviously have very wide experience, the executives and non-executives interviewed between them have explicit knowledge of current remuneration practices in many other companies, which has extended the scope of the study.

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## Notes

1. There is even a section in the Greenbury report – section 8 – relating specifically to privatised utilities.
2. As research access was conditional on maintaining the anonymity of the companies and the interviewees, no details are given about the business strategies adopted by the companies, their specific remuneration policies, nor the amounts paid to their directors. Further, where necessary some company-specific information has been disguised.

3. In each company, the executives and remuneration committee members between them held more than six other current directorships in listed companies, and had been involved at director level at more than 12 other listed companies in the last five years.
4. In one company the interview was with the outgoing consultant, in the other it was with the incoming consultant. In both cases these were the individuals who had advised on the remuneration policy and packages in the latest published accounts.
5. The term “Chairman” is used regardless of the gender of the individual.
6. Share options are known as “underwater” if the option exercise price is higher than the current share price, meaning that it would not be worthwhile to exercise the option at that time.

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"We preach more about corporate democracy than we practise." *Peter Peterson, Chairman, Blackstone Group*



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