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Ordering Top Pay: Interpreting the Signals*

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ABSTRACT Boardroom reward continues to attract controversy, despite the structural changes in corporate governance arrangements over the past decade. This study responds to Pettigrew's (1992) call to eschew over-ambitious attempts to demonstrate causality in the area of executive management and firm performance, in favour of redressing the overwhelmingly prescriptive bias in the literature. A simple but important task is to 'begin to provide some basic descriptive findings about boards and their directors', and open up 'the black box of board behaviour' – in this case, that of board remuneration committees. Interpretations of comparative market signals play a part in deliberations between the leading actors responsible for determining executive directors' salary, bonuses and other emoluments. But the position is more deeply textured than the reified influence of (global) market forces sometimes implied in the normative literature. The study reported, based on qualitative interviews, taps in to the nuances of decision taking in respect of boardroom reward management, including remuneration committee members' reactions to corporate governance reforms. Such initiatives locate non-executive directors in the role of intermediaries in the principal-agent relationship, explicitly assigned to resolve the conflict of interest inherent in boardroom remuneration systems, while simultaneously they are expected to play a team role as board members responsible for the overall strategy and operation of the company. The study is indicative: an attempt to open up research questions around the context and process of boardroom reward management that earlier analyses may have ignored or overlooked.

INTRODUCTION[1]

'Alleged compensation excesses at leading UK companies' (Conyon and Peck, 1998a, p. 146) in recent years have attracted extensive press criticism and 'a legion of academic articles' (Baden-Fuller, 2000, p. 475). The contribution of academic research to this debate for a long time was focused on searching for economic rela-

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tionships between top management pay, company performance, and firm size (Veliyath, 1999). However, failure to demonstrate robust linkages among these has recently redirected attention towards 'a richer set of social and political explanations' (Conyon and Peck, 1998a, p. 146). Researchers have, for example, examined social comparison processes and 'winner-take-all' intra-executive tournaments (Lazear and Rosen, 1981; Conyon and Peck, 1998b; Crystal, 1992; O'Reilly et al., 1988); and CEO remuneration has been studied in relation to organizational strategy (Balkin and Gomez-Mejia, 1990), tenure (Hill and Phan, 1991), the structure of internal incentives (Lambert et al., 1993), the dimensions of board structure and control (Conyon, 1997; Conyon and Peck, 1998a), and information disclosure (Conyon and Sadler, 2001; Conyon et al., 2002).

Conyon and Peck's (1998a) assessment of the empirical relationship between boards of directors, remuneration committees and top management pay is one of the few studies to examine systematically whether board monitoring arising from the corporate governance movement of the 1990s was likely to achieve its objectives. In an econometric analysis of FTSE 100 companies they concluded there was 'a complex relationship between management compensation and internal corporate governance, demonstrating that the direct effect of boardroom control variables is minimal' (Conyon and Peck, 1998a, p. 155), a finding consistent with Cosh and Hughes (1997). Despite evidence of corporate compliance with recent revisions to UK governance principles, company size continues to act as the major influence on direct remuneration (Benito and Conyon, 1999; Conyon and Schwalbach, 2000), while separating the roles of chairman and CEO appears to play no part in shaping directors' pay (Conyon, 1997). On the other hand, there is some evidence that 'the composition of a company's main board and its compensation committee are important in the closer alignment of management pay and corporate performance' (Conyon and Peck, 1998a, p. 155). Conyon et al. (2002) also find evidence to support the monitoring function of non-executive directors in the quality of information disclosed on UK company directors' share options.

However, despite changes in the institutional and economic climate in which directors discharge their duties, following the publication of the Combined Code of Practice (1998) and the 'imposition of a regulatory framework on boards' (Pye, 2002, p. 909), significant tensions remain in UK boardroom pay determination. On the one hand, we see a continuing deference to the influence of objective 'market forces'. On the other, the suspicion that senior executives are self-serving in their opportunities to exploit asymmetric information in their contractual relationships (Conyon and Peck, 1998b). Thus, the Hampel Report (1998, 4.3) states that British boardroom remuneration will be 'largely determined by the market' – a market which is 'increasingly global' in attracting business executives 'of the required calibre'. In contrast, the earlier Greenbury Committee Report (1995, 6.2–6.3) argued that despite the perceived significance of 'a market in executive talent . . . the market is imperfect':

> While market forces set a broad framework, therefore, remuneration committees for the most part have quite a wide range of discretion in setting levels and forms of remuneration. (Greenbury, 1995, 6.4)

Even Hampel, in his preliminary report, noted that a perverse outcome of the requirements for greater disclosure of directors' pay and the administration of salary surveys was to help 'ratchet up' pay levels among full-time board members (IDS, 1999, p. 3).

Significant 'space . . . to interpret situations differently' (Knights and McCabe, 2000, p. 431) thus remains for those who sit on board remuneration committees (henceforth 'Remcos'). While Hampel contradicted Greenbury's guidelines, incorporated in Stock Exchange listing requirements, that Remcos alone should determine boardroom pay, and sought to place the onus on the board itself in making the final decision, the prevailing corporate governance regime continues to institutionalize the primacy of non-executive directors' accountability in this process. Thus, executive directors are to play no part in decisions on their own remuneration (Stiles and Taylor, 2002, p. 75).

Recent structural reforms in UK corporate governance have thus raised to prominence the mediating role played by directors in determining boardroom pay. This makes even more urgent, therefore, the need to lift the lid on the 'black box' of how boards and their committees work (Pettigrew, 1992, p. 178; Stiles and Taylor, 2002) – notwithstanding the latest attempt by Sir Derek Higgs to change the actual composition of UK boards.

It is notoriously hard, however, to access information about the internal functioning of boards, and research into how directors perform their roles is rare (Rindova, 1999). One notable effort to do so has looked at the motivational effects of attitudes towards performance-related pay among top managers in a UK financial services company (Morris and Fenton-O'Creevy, 1996). However, as Morris and Fenton-O'Creevy admit, their sample and context were atypical – the market in which the respondents worked being one where variable pay was typically relatively large and the overall levels of reward high. Their questionnaire methodology was also unsuitable for investigating how boards of directors negotiate order in the boardroom (Stiles and Taylor, 2002, p. 118) in discharging their formal accountability for top pay determination.

The problem, as Greenbury (1995, 1.12) noted, is the potential conflict of interest faced by boards of directors when determining their own remuneration, between their duty to shareholders and their own aspirations as 'contracted' labour. Hampel's attempt to resolve this conflict by watering down Greenbury, who sought to reduce the dominance of CEOs by transferring control of remuneration committee business to non-executives, has meant that non-executives on Remcos are likely to perceive their room for manoeuvre being conditioned by the continuing need to secure board sanction of their decisions. Regulation of the *context and process* of executive pay determination thus remains unresolved, and fuels the scope for a negotiated order that is obscure to outsiders and prone to agency problems.

This discussion highlights two empirical issues that bear upon the successful execution of their corporate governance role by Remcos in general and by non-executive directors in particular – (1) how Remco members reconcile the ‘space for interpretation’ in discharging their accountabilities, and (2) how (if at all) they respond to ‘market signals’. Before we pursue these questions and what our study does to address these, we briefly consider two lines of theoretical work, which underpin this and which would benefit from being brought into closer alignment.

THEORIZING TOP PAY

The theorizing of top pay, in the context of corporate governance as we develop it here, relies, first, on agency theory, and, second, on the notion of a market in executive pay. As we suggest above, a clear view of the nature of the market in executive pay is necessary to ensure a real-world perspective on the agency problems involved.

Agency Theory

The monitoring role of boards of directors, in particular non-executive directors on unitary boards, who act as ‘shareholders’ first line of defence against a potentially self serving management’ (Conyon, 1998, p. 486), readily lends itself to analysis in terms of agency theory (Jensen and Meckling, 1976) – an approach which has dominated the analysis of corporate governance for almost 25 years (Buck et al., 1998). An agency relationship is defined as a contract under which a principal (i.e. the beneficial owner(s) of productive capital) engages an agent to perform some service on their behalf. Agency problems arise for investors in assessing whether they are getting the best return from the executives to whom the firm’s management is delegated. If it were easy to assure alignment between payments (inputs) to executives and performance (outputs), shareholders could simply pay their executives a fixed salary (in effect, a form of insurance payment), and then assess whether that agent is supplying optimal effort in the shareholder’s interest. That not being the case, they resort (according to the theory) to forms of variable performance-related pay.

The problem for principals is the difficulty involved in monitoring executive agents’ input, which is essentially entrepreneurial. This involves judgements and attitudes towards risk that amount to ‘hidden actions’ (Murphy, 1999, p. 26). The solution has been to offer executives a contract of employment in which they trade off some security in terms of salary for the greater risk, but potentially greater reward, of variable pay contingent on corporate performance as judged by the financial markets. As the principal's intermediary, a Remco is therefore accountable not only for establishing the value of 'insured' reward levels (the fixed salary element), but must also settle the terms of an 'optimal contract' package that combines fixed and variable rewards (Bebchuk et al., 2001).

In fulfilling this role, non-executive directors are themselves deemed to possess the 'human capital' (expertise, market knowledge, management experience, etc) necessary to monitor the management function (Conyon, 1998). The quality of their contribution is therefore crucial, beyond the structural issues of board composition (Conyon, 2000). In terms of agency theory, non-executives have 'a foot in both camps' (Pye, 2001, pp. 190–1). Hampel (1996) and Turnbull (1999) recognize that this creates inherent tensions for non-executive directors, since they are engaged both in preventing the undue exercise of power by the executive and safeguarding shareholder interests in contributing to the strategic decision making that ensures competitive performance (Pye, 2001). In other words, they also perform an entrepreneurial function, on top of their monitoring one.

Agency theory takes an essentially negative view of the relationship between principal and agents, which may be assumed to extend to non-executives as intermediaries. Little or no account is taken of 'the differing attitudes of managers, nor of the different conditions under which they operate' (Morris and Fenton-O'Creevy, 1996, p. 709), which might assuage this negative assumption. Characterizing agents as autonomous individuals whose work motivation is suspect 'creates the conditions and difficulties for social relationships' (Roberts, 2001, p. 1548). From an essentialist perspective, agency theory thus views employment relationships as no more than a series of implicit and explicit contracts with associated rights (Roberts, 2001). A more relativist perspective, on the other hand, introduces the possibility of learned and reinforced trust. Buck et al. (1998), for example, extend agency theory beyond its 'traditional financial version' to propose a Stakeholder Agency Theory (SAT). As a heuristic for structuring inquiry into corporate governance complexities in more volatile environments (such as Russia post-privatization), SAT draws attention to the possible existence of organizational cultures in which trusting relationships encourage stakeholders to suspend opportunistic actions in favour of an ethic of cooperation (Buck et al., 1998; Jones, 1995).

In the same vein, Molm et al. (1999) argue that the relative power of principals and their agents in making strategic choices is derived from their mutual dependence. The relationship between the parties to corporate governance relationships therefore becomes 'the product of ongoing interaction and discussion' (Powell, 1996; Roberts, 2001, p. 1549). Thus, although the role of the non-executive director in setting executive compensation is *formalized* in the mechanism of the Remco, the negotiation of orderly relationships within the organization is not limited to the delineation of the formal job description that defines the role and these relationships. Formal rules and procedures require judgement concerning their application, and do not cover all aspects of organizational work (Roberts and Stiles, 1999). A focus on the constitutive effect of social intercourse may be fruitful, therefore, in exploring Remco members' perceptions of the dynamic nature of executive agency as this impacts the determination of performance and rewards.

Interpreting Market Forces

Hampel argues that boardroom pay is largely defined by the market, and, indeed, it is uncontentious to regard markets as 'the most fundamental institution of modern Western economies' (Neeman and Vulkan, 2001, p. 2). A market, however, has alternative manifestations and aspects.

A market may be defined inclusively as 'any form of voluntary contractual exchange' (North, 1981, p. 42). Stiles and Taylor (2002, p. 76) report directors' descriptions of market factors as 'very important in determining executive pay' and 'a central factor in recruitment, retention and motivation'. However, the operationalization of market institutions has been subject to debate, particularly in relation to their price-making function (Polanyi, 1957). Neeman and Vulkan (2002, p. 2) contrast 'two widely used exchange mechanisms': a 'decentralized bargaining' market and a 'centralized' market. In the *decentralized* market, an idealization of what takes place in a bazaar or a Middle-Eastern Souk, exchange involves matched buyers and sellers bargaining over the terms of trade. An agreement means the traders leave the market; failure to strike a bargain implies their return to the general pool of traders to seek a new match. Transaction prices typically vary across the different matches depending, *inter alia*, on the traders' relative bargaining positions. While Souk traders may transact at different prices simultaneously, in *centralized* markets all exchanges take place at a single price with centralized clearing, such as the posted prices for commodities in a shopping mall.

Rather than treating exchanges as isolated incidents, market evolution may be emphasized, an important feature of which is the interaction between buyers and sellers (Noldeke and Samuelson, 1996). As characterized by power-dependency theory, the actions of some sellers can affect a buyer's beliefs, which in turn affect the subsequent prices at which other sellers can secure a trade. Competitive price clearing over time can be analysed using 'a simple dynamic model to study market signalling' (Noldeke and Samuelson, 1996, p. 8), in which multiple exchange partners adjust their beliefs and actions in response to learning derived from past market outcomes. There is thus a similarity here with the learning process in the boardroom referred to by Roberts (2001) and under SAT (Buck et al., 1998). Where repeat exchanges occur, purchasers engage in a series of 'screening moves' in relation to their 'offer to purchase' price signals, and sellers respond with price postings, aiming for maximum return on the exchange. As buyers become familiar with the available 'value' in terms of the *quality* of the commodity on offer, price-value assessments are revised until equilibrium is reached. A subjective dimension is thus introduced to the exchange, with judgement triggered by qualitative market signals.

In the case of the 'game theory' model above attributed to Spence, the working assumption is that a single buyer sets prices equal to expected values derived from the purchase of a commodity. In an alternative model, Cho and Kreps introduce two buyers and an auction, or 'one-shot game' (Noldeke and Samuelson, 1996, p. 8). This has some similarities with the operation of spot markets or 'competitive pools' such as those seen in energy trading (Fehr and Harbord, 1998, p. 2), where suppliers compete to supply energy through their centrally posted supply prices or bids. Such an exercise when applied to compensation packages, which deliver value to a company while motivating and rewarding executives, 'involves analyzing . . . both external (market prevalence) and internal (strategic) factors' (Lee, 2002, p. 45). However, spot prices may be invalidated owing to the structure of the market and the 'space for interpretation', which influences reward outcomes under 'contractual labor relations' (Dow, 1995, p. 1683). In the case of top executives, perceptions of the relative scarcity of talent and individual expectations may affect the relative capacity of the parties to engage in 'customized contract negotiations', a phenomenon that classical exchange theorists typically excluded from the scope of their considerations (Molm et al., 1999).

Rather than actual exchanges, however, the way market forces work in executive pay tends to be through 'comparisons with other executives in relevant industry labour markets' (Stiles and Taylor, 2002, p. 76). Such comparisons are achieved through the extensive use of remuneration consultants, who conduct surveys that benchmark referent organizations. The fixed salary (or 'insured') component of executive pay is thus likely to be a reflection of external market proxy comparisons. Given a competitive managerial labour market, the successful recruitment and retention of suitably qualified executives implies that a firm will have to offer a wage at least as high as is offered elsewhere. Conversely, 'only the component of total pay that consists of performance related bonuses can be expected to reflect the incentive aspects of the employment contract and, therefore, to be linked to measures of firm performance' (Ogden and Watson, 1996, p. 749).

The 'market' as a determinant of reward is therefore rather a loose metaphor for a number of processes that contribute to the overall structure and level of rewards, including basic pay and incentives, pensions and 'side payments'. Conceptually, these may be separated, but in practice the overall 'package' may be the real focus of negotiation. In this case, the prevailing sense of a 'market' for top pay may (as Hampel argued) never be far away in determining both fixed and variable rewards, as well as other elements whose determination is even less transparent.

RESEARCH QUESTIONS

The complexities, which both theory and practical observation suggest exist in the determination of boardroom pay by Remcos' non-executive directors, give rise to a number of research questions.

First, to what degree do Remco members appear to be influenced by the conceptualization of the employment relationship involving board directors, as a principal-agent problem that needs to be rigorously guarded against?

Second, as they interpret their duty to safeguard shareholders' interests in board decision making, what perspective of market forces informs Remcos' rationale for pricing the attraction, retention and motivation of executive directors? Do they regard this as a 'screening' process on the quality of available talent, which lends itself to a series of 'spot' price-value equilibria across the executive population? Or do non-executives see themselves engaged in auctions where performance data, interpreted in specific corporate contexts, remains ambiguous? In other words, what kind of market process do they believe is involved?

Third, what influence do other actors have in legitimizing decisions on the contractual terms for boardroom executive talent and performance? If proxy market indicators are drawn on, how do Remco members say they respond to the signals from consultants' benchmarking surveys and the greater disclosure of top pay across industry markets that this leads to? Equally, how far do externally imposed norms appear to have been internalized in the process of determining executive pay?

Fourth, what weighting is placed on the perceived expectations of executives themselves? Do they see the interactions between buyers (the company) and sellers (the executives) as leading to 'bidding-up' (Ezzamel and Watson, 1997), with executives who are underpaid in comparison with the market succeeding in negotiating reward increases, while those who are overpaid receive no parallel downward adjustment. How do Remco members view their discretion in recommending not just the quantum, but also the 'mix of compensation' (Finklestein and Hambrick, 1988; Veliyath, 1999)?

Finally, given the explicit acknowledgement by regulators of the market's shortcomings, how is the wide range of discretion attributed to Remco members interpreted by the members themselves in discharging their functions? How do they see themselves applying 'their expertise, unique business skills and decision making capacities' (Conyon, 2000, p. 1346) in discharging their function? And how do they regard the impact on their own reputations of the revised corporate governance regime (Conyon, 1998; Munter and Kren, 1995)? Do non-executives themselves see any flaws in the process of boardroom reward management, to the extent that they might agree that they are 'neither "informed buyers" of top managements' services, nor [engaged in] "arms length" negotiations' (Crystal, 1995b; Veliyath, 1999, p. 125).

There are thus a large number of questions relating to the context and process of top pay determination by board members on which we seek to throw further light.

RESEARCH DESIGN AND METHODOLOGY

The study was preceded by an analysis of boardroom movements in 81 of the FTSE 100 companies over a ten-year period (1986–95) to establish *prima facie* the extent of a market in operation (Bradley et al., 1997). Following Williams (1994), this data tends to show a relative lack of intra-company movement among executive directors, in particular internationally, thus undermining the presumption of a market in executives and hence in executive pay. Notwithstanding the criticisms that may be levelled at the way one interprets this data (which is by no means as cut and dried as appears), the real issue is not whether or how far a market exists, but whether it is perceived to exist. It is the perceptions and beliefs of Remco members that matter, insofar as these determine their actions and behaviour. As Thomas put it, 'if men define situations as real, they are real in their consequences'. This calls for a qualitative research design.

The study reported here is based on privileged access to key actors engaged in the business of boardroom appointments and reward determination. The primary data comprises in-depth interviews with seven individuals who between them chaired or sat on one-fifth of the FTSE 100 listed companies' remuneration committees (see Table I). While this may appear a small sample, multiple office holding is common among this population – for example, around two thirds of Pye's sample of non-executive directors had 'at least two FTSE 100 directorships' (2001, p. 191). The result was a small group of individuals, but with a large number of boardroom appointments between them. In his study of managerial elites, Pettigrew (1992, p. 178) refers to such people as 'network stars'.

In forming our sample, a degree of opportunism was exercised, as indeed has invariably been the case in studies involving boards. Such individuals, for example, do not often make themselves available to talk frankly about areas as controversial and personalized as top rewards. The sample was therefore constructed as one might weave a web, with each additional interview granted providing the credibility (and often the direct introduction) to pursue the next. Pettigrew and McNulty (1995) relied on a similar process.

This data was then supplemented by telephone interviews with five prominent recruitment consultants specializing in board and senior executive placements (Table I).

As both Roberts and Stiles (1999) and Pettigrew and McNulty (1995) note, there is a paucity of data on the 'close operation' of boards. The present study attempts to address this gap by examining the ways non-executive directors interpret the variety of influences on their accountability for determining executive directors'

Table I. Remuneration Committee members and search consultants participating

Remuneration Committee members
Sir Michael Angus
Sir John Banham
Jonathan Charkham
Anne Ferguson
Richard V. Giordano KBE
Sir Alastair Morton
Frank Sanderson
Executive search consultants
Janet Albert, GKR
Peter Chalkley, Sabre International
Michael Curlewis, Boyden International
James Hervey-Bathurst, NB Selection
Alan Winton, Russell Reynolds Associates

rewards. To retain flexibility in data gathering, this required semi-structured interviews that allowed respondents to reveal their perceptions concerning the range of factors they deemed to be relevant to their role as Remco members and as board directors. A broad agenda for discussion was prepared in advance, based on a review of the existing literature, to avoid what Roberts and Stiles (1999, p. 38) coyly describe as the risk of 'an early exit from the interview', while avoiding also too tight an *a priori* classification of data (Roberts and Stiles, 1999). This allowed respondents to talk around the questions and to develop any points they believed were important to them as directors or in terms of wider corporate governance concerns. The topics covered included:

- their impressions of boardroom turnover;
- the part salary surveys play in determining rewards;
- the types of packages needed to lure executives away from their previous positions;
- how aware executives are perceived to be of their 'market value' and where they get this information;
- the perceived role of, and criteria used for, determining fixed and contingent remuneration and benefits;
- the issue of governance restructuring and the role of the non-executive director.

These topics tap into the five research questions previously identified, with the agency issue embedded in the determination of fixed and contingent remuneration.

The interviews with executive search specialists were conducted by telephone. In this case, we were particularly interested in the following:

- the sectors where turnover was most prevalent;
- any observable trends indicating change;
- particular posts where most turnover was evident;
- typical premia agreed to lure executives from existing positions;
- perceived awareness among executives of their 'market worth'.

Mirroring the precepts of Roberts and Stiles (1999) and Glaser and Strauss (1967) for developing 'grounded theory', data collection followed the principle that there should be flexibility for ideas and insights to emerge as the programme of interviews moved forward and for these to be tested in succeeding interviews. Thus, some deviation from the question format benefited the analysis.

All face-to-face interviews with the Remco directors were conducted by two researchers, with one leading the questioning at any one time and the second recording the discussion. Tape recordings were considered to be insensitive to the profile of the subjects and the sensitive subject matter. Interview transcripts were then analysed to identify emergent themes, and data from the interviews with both Remco members and consultants used to cross-validate and contrast views on the five research questions as the latter were crystallized.

INTERVIEW FINDINGS AND DISCUSSION

Our findings are organized as follows in relation to the five research questions. First, Remco directors' impressions and application of 'market signals' are presented (Q2). Second, their perceptions of agency factors and the influences on them of other board members are set out (Q1), along with the influence of the 'contract' aspirations they attribute to executive directors (Q4). In the process, the influence of consultants and pay surveys is discussed in relation to both issues (Q3). Third, attention is directed towards the perceived effects of corporate governance restructuring initiatives on the process of boardroom reward determination (Q5). In all cases, comments are unattributed in order to preserve anonymity.

Perceptions of the Executive Market

When directly confronted with questions concerning the market for top pay, a number of respondents were anxious to stress its imperfections and idiosyncratic nature. One Remco director categorically denied the existence of a recognizable market for executives, 'certainly not like that for beef or shares'. Instead there are 'just key people in unique positions at a given moment in time, who are not readily interchangeable'. Consequently, like-for-like comparisons were impractical. An example was cited of retail companies, Tesco and Marks & Spencer – superficially the same, but with a different ethos in terms of employee orientations to the business, and the way the organization treats its people and they one another. If there was a market, it was therefore an 'imperfect market', 'analogous to that for large country houses'. The benchmarks that determine price came down to individual cases:

> For example, you might rate Palladian pillars highly, but the next person may not be so interested in them.

As noted, we carried out an initial review of boardroom movements in FTSE 100 companies to determine what objective evidence there might be for the existence of a market for 'top talent'. How do those close to this 'market' perceive the extent and trend of such movement? The search consultants all indicated that the number of assignments over the preceding five years had increased. However, it is not clear whether they had been witnessing a growth in changes in boardroom appointments or a growth in the propensity to use executive search firms to fill them. Executive 'churn' also seemed to be concentrated in certain sectors, associated with the cyclical changes in business fortunes and technology.

Remco members' perceptions were consequently inconsistent. Opinion varied between those for whom the market was 'tight', making it 'difficult to lever people out', and others, who perceived enough executive mobility to maintain a sense of equilibrium. One Remco member was unequivocal in stating that 'the level of turnover for top executives does seem to be speeding up', while another equally believed 'board turnover is not great' and the main trigger is usually retirement. For the first respondent, a particular indicator of increasing mobility at the top was 'the way individuals spring-board between jobs in order to progress in salary as well as position', rather than through a single-firm career. Chief Executives and Financial Directors were cited as particularly opportunistic. In the second case, where the Remco member's experience was of more modest movement, especially in large companies, sophisticated arrangements for management succession were thought to reduce turnover (and thus, presumably, enable a smoothing in pricing top level appointments). While moving 'for the money' was cited, respondents mostly argued that this is not the reason executives leave firms. For example, 'some are pushed'. A large unplanned 'leakage' would be a signal to a board, indicating perhaps that its management style and strategic direction was wrong.

Overall, the lack of consensus on executive mobility suggests that any market exchange dynamic is 'decentralized', in Neeman and Vulkan's (2002) terms, and heavily influenced by locally contingent factors. This uncertainty about how much movement there is and whether it constitutes a market is reflected incidentally in problems in interpreting objective data gleaned from company reports.

Hampel's (1998) reference to the impact of an international market, suggesting the emergence of a more cosmopolitan 'top team', as companies faced up to global market competition, was explicitly tested. If this perception was shared by Remco members, did it imply that top rewards now had to be benchmarked against some form of international standard?

Information from the search consultants may well reflect the international networks they have established and seek to promote, rather than broad trends. For this reason, the anecdotal evidence of Remco members may be more reliable. They viewed international turnover in top executives as limited and quite stable, language being the main barrier. In general, only at chief executive level was it felt possible to anticipate a substantial international source of executive appointments, and this was seen as mainly confined to English-speaking areas (primarily the UK and USA). While Continental Europeans were credited with the ability to speak multiple languages, which might facilitate their mobility between states, it was considered rare to see an English native being considered for appointment to a board in a non-English-speaking country. While cross-border movement of executives was expected to have only limited impact on reward levels, Remco directors did highlight problems experienced by firms with a UK-based board and stock market listing but a revenue stream and associated senior managerial workforce concentrated in the USA. The implications of 'astronomical' executive pay in the USA means 'riding a difficult course', coping with reverse pay differentials in the management hierarchy. But it did not create the conditions for a 'centralized market', but rather a localized decentralized one (Neeman and Vulkan, 2002).

While the evidence for a market with price as a clearing mechanism remains questionable, therefore, there is certainly no widespread subjective sense of such a market among those who are closest to it. Rather, there are a series of localized bargains.

Perceived Agency Considerations, Board Social Influence, and the Use of Data

As already noted, subjective factors appear to dominate Remco directors' price-value rationalizations. No objective criteria were offered by interviewees: rather, they exercised a sense of 'judgement and fit', arrived at through discussions. This obviously opens up the process to a variety of social influence factors.

Remco directors have to contend with a number of different interest groups – executive directors, non-executive colleagues, and institutions. First among these influences are the dominant members of a Remco and their relations with other members of the board. This highlights the problem of non-executives' role ambiguity and power disparities within and around the boardroom, which expose them to the influence of powerful CEOs and chairmen in deciding executive pay. At a minimum, they may simply wish to 'stay in management's good graces' (Conyon, 1998, p. 490) so they can be re-elected and continue to collect their fees.

The network links among members of remuneration committees in different companies may also fuel a vested interest to be generous (Garrett, 2003). These inter-linkages were acknowledged by Remco members, but resulted not necessarily in 'bidding up', but seeking to make awards that were perceived as fair across their own network of companies (a form of subjective comparator). A common practice, which is more pernicious than the existence of inter-linking boards themselves, it was argued, has been to use the 'network' to appoint friendly faces as non-executives. This does far more to undermine the policing of the principal-agent problem. The increasing use of head-hunters to make non-executive appointments was felt to be changing this aspect, however.

Consistent with Stiles and Taylor's (2002) findings, Remco respondents confirmed that formal sources of benchmarking data on executive reward levels were derived from consultants and salary surveys. However, such surveys were viewed with a certain amount of disdain by the Remco directors we interviewed. They are 'a necessary evil', but it was felt over-reliance on them can frustrate compliance with the exhortation of the Combined Code (1998) to 'avoid paying more than is necessary'. This accords with the concern about executive pay inflation expressed by Hampel in relation to the Greenbury disclosure provisions (IDS, 1999). It also implies a view that executives may act opportunistically in setting agency contracts where 'hard' evidence offers encouragement to do so, even though the robustness of such data is felt to be questionable.

Thus, while salary surveys were not necessarily viewed as the best way of getting information, gathering data was perceived to be important in determining salaries and total remuneration packages. The key role of data was in legitimizing agency cost bargaining in setting salaries and shaping bonuses, although a 'different conversation' was required on salary than on the variable part of the reward package. Remco directors were concerned, however, at the ways in which aspects of their interaction with executives to set rewards had become blurred as a result, and cited Greenbury (1995) as an attempt to highlight the dangers of baldly taking survey data. The prime example of this, they acknowledged, was in the privatized industries, where flotation prospectuses 'claimed alignment with private industry' to make good allegedly unfair treatment in the past on the basis of size of capital considerations. Thus, 'the discounting of stock options by 20 per cent in monopolies, resulting in massive gains from one day to the next' was felt to have exacerbated the agency problem across industry generally. The implication is that any form of price-value market calibration by intermediaries acting for the new owners had been fatally undermined.

Arguably, of greater practical relevance to Remcos in giving 'space for interpretation' is the gap in survey information on performance comparisons. Triggered by increased pressure to appear to be controlling executive rewards, our Remco members claim to have become more challenging of surveys and commissioned data. They want rigorous explanation of where data is coming from. In the words of one respondent:

> The most experienced directors know they are working in a transparent environment. They know that they need to be fair and that good logic and common sense must prevail in decision-making.

However, they sensed a danger of being manoeuvred into acceptance of reward levels based on comparisons unrelated to performance, which fuelled an upward spiral. Thus, consultants engaged by managements to 'advise' Remcos were felt to be encouraging a 'pernicious process of choosing comparators' that 'just leads to the ratcheting up of top pay'. The problem becomes particularly acute when companies all strive to achieve the statistically impossible feat of setting reward levels to locate themselves in the upper quartile of their benchmark group.

The role of consultants here provides a salutary reflection on the complexity of the market-making process, involving a variety of bargaining agents, which is a far cry from the picture of simple buyers and sellers and of non-executives tasked with resolving inherent agency problems. We are reminded of similar complexities in evolving markets such as professional football, where not only do agents negotiate the salaries and fees of footballers with clubs, but in representing players in different countries stimulate the international transfer market and participate themselves in international networks of football agents. The market for executive pay lends itself to a similarly complex dynamic.

Despite these concerns, Remco members did not expect the practice of benchmarking to be discontinued, however. Their focus was on improving the validity of choices made in selecting comparators. Remco directors appear to feel frustrated in assembling the means to validate the return on agency costs. This echoes the note of caution sounded by Jensen and Murphy (1990), concerning the imperfect knowledge held by principals regarding business development opportunities open to their agents. Optimal executive 'sweet spot' (i.e. mutually favourable) contracts (Lee, 2002) depend not only on securing the principal's objective (i.e. change in shareholder wealth), but also on any variables contingent on the circumstances of the organization concerned. It is the latter that provide incremental information valuable in assessing executives' unobservable choices of action.

Concerns have been expressed regarding the power of executives to influence the form, timing and quantity of performance incentives. Their position relative to principals and their intermediaries on the Remco may enable executives to camouflage or manipulate the basis on which they realize benefits. For example, when long-term incentive payouts are dependent on performance measured against a 'basket' of peer companies, executives may exploit the absence of generally accepted norms, selectively defining comparators in self-protective ways (Veliyath, 1999). Here the role ambiguities of Remco members were most keenly felt, where they were held accountable to institutional investors who seek to optimize agency considerations, while working side-by-side with executive directors as members of the same board. One respondent summarized this as follows:

> Perhaps the Remco should be made up of the most miserable bastards on the board. It will always be a tug of war . . . they must live with the guy afterwards . . . You don't get popular making tough decisions (for example, pulling the expected 37 per cent group bonus back to 22 per cent), but that is what you are there for.

While not consciously engaged in bidding up top pay rates, the influence of common reference points among elite groups can be an undoubted factor. One respondent went so far as to question the capacity of fellow Remco directors to act dispassionately when discharging their governance roles in relation to reward on the basis that 'What would you expect butchers to answer, when you ask what your diet should be?' Within the network of prominent non-executive directors, many of whom are themselves highly rewarded executive directors in their own companies, norms of what is perceived to be high or low are contingent on their individual experience. That is to say, if the name of the game is high pay, that is what the discussion delivers. In other groups different values apply:

> If you were to ask clerics or university lecturers the same questions they would probably focus on something else . . . the name, reputation and success as counting for more.

On the other hand, institutional factors and the actual and perceived capacity for Remco members to control the environment for decision taking was keenly felt by some. Remcos usually meet three times a year. They can ask for more data and may form a sub-committee to review this outside the designated meetings. Logistically, the process can be difficult, however. Also, management of the dynamics of the relationship between committee members and the business is far from straightforward. Remcos consider policy on executive pay. However, the committee chair will ultimately determine the specific application of policy to individuals, usually in consultation with the CEO, who is normally invited to propose schemes. A further conflict is over recruitment to executive positions being led by the chief executive and company chairman:

> They sit down and define jobs and qualities and give terms of reference to headhunters. By the time the remuneration committee is involved, the die has been set.

The issue of who sets the agenda for board interactions, thereby narrowing potential agency cost control outcomes, has been aired by Jensen (1993) and Hart (1995). A Remco chair is expected, under this scenario, to retain a sense of control through informal 'dialogue' on behalf of the committee, to avoid giving the chief executive 'too much freedom' to influence agency costs.

Some Remco members argued strongly in favour of non-executive directors taking the lead in collating executive reward management data, and driving the overall process. Others said Remco members should avoid the temptation to 'interfere with the management role of the business . . . and interfere with contractual rights', a concept rejected practically as 'naïve'. Remco chairs were felt to have a taxing job, requiring them to know the company and its personalities well, and drawing on this knowledge to guide Remco members' deliberations. On the other hand, the committee chair must explain these decisions before the much larger population of interested parties at the annual general meeting.

The conclusion here is that Remco directors are acutely aware of the principal-agency problems they have to negotiate (even if they do not phrase it precisely this way), but the ambiguities and weaknesses of their role, coupled with imperfect performance-reward data, do not allow for an easy or obviously satisfactory resolution of these. The workings of a market in executive pay are fatally undermined by the social realities.

Perceived Aspirations among the Executive Population

Remco directors are not the only 'voice' that influences executive reward determination – executives themselves have a powerful voice. Buck et al. (1998), for example, contrast the balancing role that 'exit' and 'voice' factors can play, where top managers are regarded not merely as agents, but as a 'dominant stakeholder' group in the firm. It is reasonable to expect that boards seeking stability among the top team take cognisance of executives' awareness of their own value and their willingness to move for bigger rewards. We therefore asked our Remco directors about executives' motivation and how they value themselves.

Interviewees commented that the 'going' rate aspired to by executives was made by 'the 2 per cent movement at the margins'. The pay of other executives then gets carried along. Crystal (1995a) especially has criticized this bidding up of top pay whereby an overpaid CEO effectively 'sucks up' the pay of subordinates so that they are overpaid too. As a result, 'it is mainly mediocre executives who use the internal equity argument'. When executives in Company A make a 50 per cent bonus, senior managers in Company B, even though failing to demonstrate the same performance level, still ask 'where's mine?' There was no consensus on where Remcos set the limits in this respect. Some thought the effect of trying to 'cheat the market' through claimed comparisons would be a general discontent among executives, while another expressed a sense of exasperation:

> There is neither a moral nor a market argument to justify the explosion in pay, but once started, it is hard to stop. You cannot be seen to be left out.

Among executive search consultants, there was a consensus that executives seem quite aware of their market value, which they develop in the course of networking with fellow executives; and though British executives were not yet as sophisticated as their US counterparts, who commission their own salary surveys to support their pay bargaining, it was anticipated this trend would spread to the UK. Likewise, according to Remco directors, the transparency and detail of boardroom pay in the public domain post-Greenbury has made some executives 'acutely aware of what the market is paying'. Equity sensibilities then come into play. Once aware of rewards achieved by other executives, '80 per cent will think that they are performing better than that and will want it reflected in their pay, although, in reality, perhaps only 20 per cent could justifiably introduce this argument'. It also 'only takes one or two appointments of [transatlantic] foreigners to destabilize the system'. Occupational function was also seen as a contingent factor, so that while Finance Directors were 'not as sophisticated as they might be' in bargaining over their own pay, commercial directors were 'more adept at negotiating'. Chairmen, in particular, although sometimes apparently paid a lot relative to the time commitment they make, 'know that they have enormous experience which is in demand'.

Executives are perceived (not surprisingly) as highly competitive, which affects their expectations for reward:

> Most executives regard reward packages as a scorecard. If they don't have as many ticks on theirs as others, it will cause problems.

Inattention to the basics will certainly give rise to negative motivation, if the rewards on offer are regarded as 'too low to sustain a lifestyle'. However, intrinsic satisfactions and non-monetary perks are also key factors:

> A prime motivator for executives is to do a good job. Top executives love the adrenaline flow of achievement.

Executives aspire to the right level of 'psychic income':

> Once you get to the main board, part of the fun is staying in the Shangri-La in Singapore . . . The perks are having a chauffeur, having a good executive lunch in a top hotel, and being sent on international business. These are all considered an integral part of the life at the top.

Thus, 'it's not just about money; it's about what the money says'. Challenge, status and power matter, although risk-aversion in various forms remains implicit. For example:

> It is sometimes more interesting and rewarding to go into a company that is badly run with the opportunity to make a positive contribution, than to follow in the footsteps of a good CEO with whom you risk unfavourable comparisons.

The language used thus suggests executive self-image and aspirations are highly material in concluding acceptable rewards. This fits with Roberts' (2001) argument that executive identities are socially constructed through a series of accountability framing routines, expressed here through pay and rewards. Remco directors therefore see themselves as responsible for ensuring that executives are satisfied with the overall package of rewards and are fairly treated in comparison with others (Adams, 1965).

An added complexity, however, is the employment security associated with internal and external appointments. Remco members argued that in companies where senior managers have the experience, most vacancies at board level will be filled by internal promotion. If there are succession gaps, and candidates are sought from outside, the security of their current post is felt to be a major influence on the contract terms demanded for joining the recruiting company. In agency terms, the financial incentive will need to offset the perceived risk to the individual. But there are exceptions to this. If someone is frustrated in their existing company, it may not be more money that is needed, but opportunity. Hence, as one respondent phrased it, putting the focus on more holistic deal-making, 'the thing you have to "wrinkle out" at the first hurdle is money'.

An enormous amount of attention is given to the construction of performance-related pay for top executives. This fuels a vast industry of remuneration consultants and senior HR professionals in large companies, and is the focus of shareholder attention at AGMs and in the financial and popular press. The mechanisms of such schemes are a source of endless fascination to those who devise them. However, while not wanting to discount their significance in trying to establish objectively defendable resolutions to the principal-agency problem, the picture that emerges from Remcos is of a much more holistic debate on rewards. As one put it:

> Total pay is not comparable. You need to see where people came from and the responsibilities you expect from them.

Top pay determination by Remcos is thus attuned to a range of contingencies on an '*ad hominem*' basis. This recognition may help to focus attention on the range of elements within total pay, including long-term security payments (pensions, etc), and not just present performance-related elements.

Governance Prescription and Outcomes

In the light of how market signals are interpreted, the complexity of institutional contexts, and the role of executive egos, where does this leave corporate governance restructuring? As already noted, Remco members feel the increased transparency in boardroom reward reporting has contributed to raising consciousness among executives regarding 'market equity'. This has lead to a somewhat self-defeating search for consultancy packaged benchmarks, which themselves contribute to upwardly spiralling agency costs (cf. IDS, 1999), as the visibility of these packages encourages comparisons, US-style.

Thus, transparency is viewed as a mixed blessing. On the positive side, Remco members interpret it as a possible force for the exercise of more informed judgement, based on a better grasp of the detail of executive reward management. In the past, non-executive directors had to rely on survey information from remuneration consultants without necessarily knowing how this information had been arrived at. The new regime may force Remcos, in their intermediary role, to challenge data procured by management, in order to safeguard their own reputations in exercising a monitoring role (Conyon et al., 2002). On the other hand, this visibility may encourage continual argument around comparisons, emphasizing the tensions inherent in non-executives' governance and top team roles (Pye, 2001). Since everyone tends to think they are better than the average, equity will be sought with the higher performers, risking the 'suck up' effect noted. Past evidence indicating very little link between directors' pay and company performance (Conyon and Leech, 1994; Gomez-Mejia and Balkin, 1992; Gregg et al., 1993) has been counter-balanced to some extent by corporate governance restructuring. But the relationship remains complex (Conyon and Peck, 1998a), and Remcos find themselves swamped in seas of readily accessible data that require skilful interpretation. Added visibility puts the media spotlight back on the absolute values of executive rewards:

> If someone is highly paid now, they need to stand up and explain. Greenbury helped to provide information to report to shareholders, which otherwise would have been difficult to find out. It helps companies think about the data fed to them by outside directors.

However, transparency and increased disclosure also have unintended consequences, which are then buried in less evident decision making processes:

> Previously when we had a new person, they would be brought in at a lower level, and given an increase to full market level only when they had proven they could 'cut the mustard'. Today, I am inclined to include the full increase from the beginning. This is because prurient journalists look at percentage annual

increases without looking at the reasons. This is one of the problems of total disclosure.

The pressure of more data in the wake of the Combined Code puts greater demands on consultants to interpret salary data. Remco members have important things to say about these consultants' changing contribution. There is felt to be a role for salary surveys if they are constructed better, and for better 'agency management' data, with information about value creation, the criteria for determining bonus awards, and differentials between jobs. Structural, sectoral and business cycle factors need to be included. Thus, pay determination for executives in a mature business should not be based on importing inappropriate norms from elsewhere – for example, from a high value-added, high technology multinational. Companies facing similar business problems need to be examined in order to make valid comparisons. Remcos need to be thinking through the issues necessary to secure the right information base, and since 'no consultant is better than the question he gets asked', Remcos need to take charge of the wider process more effectively than currently. What has been missing from consultants is 'quality information of the right depth and breadth reflecting business structure, circumstances and performance factors'. The issue remains whether consultants are able to rise to the challenge, and creating the right the boardroom climate to guide them.

CONCLUSION

This paper has described the ways in which a sample of FTSE 100 non-executive directors use the 'space for interpretation' of context and process in discharging their boardroom pay accountabilities. A number of empirical questions have been surfaced, based on a review of the 'top pay' literature, and these have been explored through interview data, and further avenues for research opened up. One such area is to ask how executives themselves see these processes, and how their perceptions correspond to those of the non-executives. Our focus here, however, is confined to non-executives (and their use of remuneration consultants) on the grounds that it is they, not the executives themselves, who are supposedly the key players on Remcos in executive pay determination. Specific conclusions may be summarized as follows.

Market Learning and Executive Pay Setting

While (proxy) market comparisons have been encouraged by more comprehensive disclosure of total executive rewards, members of Remcos perceive constraints on their ability to calibrate price-value norms objectively due to idiosyncrasies that require 'artful' assessments of individuals and roles (Noldeke and Samuelson, 1996). The price-value placed on a specific executive may depend more on the characteristics and preferences of the purchasers (company) than on the 'commodity' itself. This confirms the continued operation of a series of decentralized contractual exchanges (North, 1981), where appointments and subsequent reward determination are made contingent on specific circumstances. There is thus no widespread subjective sense of a market among those who are closest to it, but, rather, a series of localized bargains, or 'spot market' transactions.

Institutional Factors and Normative Compliance

Spot market transactions, however, in contrast to large-scale market clearing operations, create a 'space for interpretation' in determining pay (Dow, 1995). Non-executive members of Remcos see themselves being compromised in attempting to reconcile internal equity considerations and corporate governance transparency. Factors such as power imbalances between the principal actors, role ambiguities, and the classic principal-agent problem of imperfect reward-performance indicators leave Remco members feeling at times out-manoeuvred. As shareholders then exercise their 'absolute rights to question management' about boardroom reward governance and as non-executives' reputations are exposed to media scrutiny, more covert behaviour may result (Pye, 2001, p. 193). Ordering top pay may then prove to be contingent more on 'communication' than performance management considerations. In other words, what matters is how rewards appear, not whether performance is being objectively over-valued. The added element is public opinion.

The Adequacy of Agency Theory in Reflecting Social Processes

As soon as we acknowledge this, it exposes a long-standing weakness in the way the agency problem has been framed in respect of top pay. Agency theory begins from an essentially negative view of principal-agent relationships. The problem is lazy CEOs whose motivations are suspect. The risks of shirking and self-interested behaviour have therefore to be guarded against. The negotiation of pay thus pitches the private goals of the executive to maximize their income, against the shareholders' goal of maximizing their returns from wealth-creation. Competent performance – which is presumably fundamental to the latter process – is itself not an agency problem (shirking apart), but only becomes so insofar as executives seek to structure reward packages that give them readily achievable targets.

The weakness in this whole scenario is the hermetically sealed world it inhabits. The issue is not just executive and shareholder goals, but publicly acceptable pay norms and differentials. The more Remcos adjust their thinking and behaviour to this – even if it is just to present rewards in a more favourable light – the more they move out of the narrowly defined world of agency theory. Governance is then not a matter of how the spoils are divided, but a wider stakeholder issue.

An alternative route to this is to question what exactly CEOs bring to company performance. Some studies suggest that CEOs alone make only a marginal difference to performance. Indeed, there is more spectacular evidence that misjudged CEO and board decisions contribute far more to destroying value than creating it (for example, GEC/Marconi, to name but one case). It may be better therefore to characterize the CEO role as one of 'stewardship' than driving increased value. The fact that there are stronger correlations between reward packages and the size of companies than with performance (Benito and Conyon, 1999) suggests this view is widely and implicitly held. In some cultures, stewardship is quite clearly more highly valued. The agency issue is then subsumed within the wider question of what we want from our executives.

Taking these together – what society wants from companies in terms of 'good governance', and what shareholders might truly value in executive performance – it becomes apparent that the performance criteria adopted in agency theory discussions of top pay are inadequate and tend to obscure the wider social processes around these issues.

The Non-Executive Role

This can only add to the complexity and ambiguity in which Remco directors find themselves. Willy-nilly, they are part of an agency-principal problem, in which it is difficult to operate unequivocally as representatives of the shareholder principal. After years of trying to address governance issues and pay through codes of practice, the problem of the non-executive role itself and the quality, independence and effectiveness of non-executives has not surprisingly now come to the fore. The Higgs Review (2002) and subsequent proposals imply that the problem lies (in part) in a narrow population of non-executives – by implication, self-perpetuating, self-interested, and inevitably collusive by virtue of a common social background. Board composition thus contributes to a culture that eschews frankness in favour of restrained expressions of critical views, and dampens whatever corporate control might be exercised through non-executives (Jensen, 1993).

Widening board membership and reconstituting Remcos to give independent non-executives more sway may be a considerable advance. However, such structural changes are likely to remain vulnerable to social and political influences, which compromise notional independence, even if these develop a different form than at present. Continuing, and more systematic, constant attention to these social and political processes is necessary. Indeed, one might argue (not entirely whimsically) that the greatest contribution to effective corporate governance in the area of pay that legislation of codes of practice might make is the appointment of a social scientist as an observer to remuneration committees with a brief to report on their functioning.

NOTES

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