

"Questioning the Remuneration Committee Process"

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21 February 2007

Thanks are due to each of the remuneration committee members who participated in this study and to Christine Wilkinson who transcribed the interviews. We are also grateful for comments received at a seminar in the 'Corporate Governance at the LSE' series. Remaining errors are our own.

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Abstract

Before 1992, few people knew or cared whether a company determined the pay of its top executives by making use of a board sub-committee known as the remuneration committee. Starting with the Cadbury Committee, however, the subsequent decade saw this organisational arrangement move centre stage in what has become an increasingly heated debate regarding executive pay. While it is true to say that top executive pay remains unregulated in the UK, the same cannot be said for the process by which it is determined. The practices and procedures of the now near universal remuneration committee are carefully prescribed in self-regulating codes and institutional guidelines. These have moved the expectations held regarding the role of the remuneration committee from simply being a guarantor of the probity of the pay process to one of performing a key principal-agent role in the strategic human resource management of the company.

Using evidence drawn from a series of interviews with current remuneration committee members, this paper examines the functioning of remuneration committees in terms of the effectiveness of current executive remuneration processes in the UK. The following conclusions emerge: remuneration committees feel constrained in their choice by an institutional isomorphism of remuneration design, particularly with regard to LTIs; they commonly fail to allocate the time or resource to calibrate or confirm the effective operation of the chosen remuneration plan; and many of their actions are dominated by a perceived need to be able to justify any high pay outcomes in communications with shareholders and institutional investors. We are therefore left with the possibility that the way in which remuneration committees currently conduct their business limits the extent to which they are able to live up to the high expectations placed upon them in terms of effecting an alignment of executive interests with the critical success factors of corporate strategy.

KEY WORDS: *corporate strategy; executive pay; institutional isomorphism; principal agent; remuneration committee; strategic human resource management.*

Introduction

This paper makes two basic points. The first is that over recent years what is expected of remuneration committees in the UK has changed markedly. In particular, it is no longer sufficient merely that they guarantee the probity of the pay process at senior levels of the company. Remuneration committees are also expected to play a key principal-agent role in joining up the pay incentives of the top management team with the critical success factors of corporate strategy. The second and more contentious point is that current practice may not be sufficient to meet fully this aspect of the changed expectations regarding remuneration committee function.

In the following discussion, extensive use is made of what has been a recent upsurge in research on the topic of remuneration committees and, because of what shall be argued to be the very strong institutional influence in this area, most of the discussion focuses on UK experience and practice. We are able to draw on a series of interviews recently conducted with some 22 directors who, among them, serve on the remuneration committees of 33 publicly traded UK companies¹. Responses gathered during these interviews are used to evaluate the hypothesis that current remuneration committee practice has yet some way to evolve if it is to live up to expectations.

Remuneration committees emerged as a topic of academic research as recently as the early 1990s². While companies, of necessity, always had a mechanism by which the remuneration of senior executives could be set and adjusted, the arrangement that is now identified with the remuneration committee did not appear in popular discussion until that time. The work of the Cadbury Committee (1992) created the first exposure of the arrangement in policy circles and interest has waxed and waned ever since – mostly reflecting subsequent governance reports (Greenbury, 1995; Hampel, 1998; and Higgs, 2003).

The series of reports mentioned above define the emergence of what has come to be seen as the UK ‘Comply or Explain’ approach to governance, set out in various

¹ Of the 33, there are 27 companies which are traded on the London Stock Exchange.

² For the UK, see Main (1993) although the topic of compensation committees has a much longer research pedigree in the USA, e.g., Harrison (1987).

versions of the ‘Combined Code’ (1998, 2003, 2006). This impetus for change was further bolstered by the activity of institutional investors, acting through individual ‘guidance’ or through bodies such as the Association of British Insurers (ABI), the National Association of Pension Funds (NAPF), or the Performance Pay Group.

The next section of the paper briefly spells out some of the changes that took place post-Cadbury to the (self-) regulatory environment in which directors’ remuneration is determined in the UK. It is argued that a clear expectation has been placed on the remuneration committee that they will design the incentive aspects of remuneration arrangements to align the interests of the top management team with the attainment of the critical success factors central to the company’s business strategy. There is then an analysis of the extent to which current practice suggests that remuneration committees find themselves able to address these principal-agent considerations. This draws on recent interview evidence collected by the authors from remuneration committee members. The concluding section of the paper offers some thoughts as to how things might be changed to bring a closer alignment between expectations and outcomes.

Rising expectations

This section tracks the increasing level of institutional involvement over recent years in the setting of executive remuneration in the UK. Difficult as it may be to believe today, there was a time when public companies in the UK were basically allowed to set the pay of their senior executives with little fuss or attention. Following the passage of the 1967 Companies Act, it became a requirement to disclose the pay (‘emoluments’³) of the chairman and of the (unnamed) highest paid director in each company’s Annual Report, along with the pay distribution of other executives – suitably tabulated in anonymous £5,000 bands. But when the Cadbury Committee (1992) was set up to consider financial governance practices in British boardrooms, it also found itself addressing the process of executive pay determination. This led to the first recommendations regarding the establishment and operation of remuneration

³ ‘Emoluments’ essentially being base plus bonus and the cash-equivalent of perquisites received.

committees⁴ and was soon followed by the Greenbury study group (1995), the Hampel Committee (1998) and the Higgs report (2003) each of which further delineated the membership and procedures required of remuneration committees. The Combined Code on Corporate Governance (1998, 2003, 2006) offered a unified and up to date version of these requirements⁵.

All of these Code requirements operate under the condition (for listing on the London Stock Market) that a company either comply with the code or explain why they are not so doing. This is a very different approach from that in the USA with its legally backed strictures of the Securities and Exchange Commission (SEC, 1993, 2006) and mandatory conditions for listing on the NYSE (2004) or NASDAQ (2003). Only in terms of disclosure and the advisory vote has any statutory intervention been made in the UK, and this in the form of the Directors Remuneration Report Regulations (DTI, 2002), which require detailed reporting of directors' remuneration at a level of detail consistent with the Combined Code.

But what truly distinguishes UK arrangement from those in the USA is the way that British institutional investors⁶ have been prepared to set about influencing the conduct (as opposed to the structure) of the remuneration committee. While UK institutional investors always took an interest in governance matters, it was the introduction of approved executive share option schemes under the 1984 Finance Act that led the institutions to exert their increasingly dominant influence on executive reward⁷. The prospect of equity dilution caused the institutions (and, in particular, the ABI and the NAPF) to issue guidance as to how such schemes should be administered⁸.

⁴ Braiotta and Somner (1987) note that by 1985 in the USA 86% of top 1000 companies had compensation Committees and of these 70% comprised outside directors only.

⁵ In the 2006 revision, the chairman is now permitted to serve as a member (but not chair) of the remuneration committee.

⁶ Identified for these purposes by Charkham and Simpson (1999, p166) as: the National Association of Pension Funds (NAPF); the Association of British Insurers (ABI); the Association of Unit Trusts and Investment Funds (AUITF); the Association of Investment Trust Companies (AITC); and the Institutional Fund Managers Association (IFMA).

⁷ As part of the 1984 Budget, what was then a major tax concession was granted in the form of approved executive share options. Approved schemes allowed gains to be taxed as capital gains rather than income (a difference of 30% versus 60% marginal tax).

⁸ In recent years, commercial ratings services have been developed by both the ABI (as IVIS) and the National Association of Pension Schemes (as RREV). These evaluate, among other things, the Directors Remuneration Report. In the case of IVIS, a traffic light coding is used comprising of blue, green, amber and red, in order of decreasing approval. A company will speak of being 'red-topped' or 'amber topped', reflecting the IVIS website's representation of this grading of their DDR.

At the outset, these ‘Guidelines’ (for example, see ABI, 1987) were essentially concerned with regulating the uptake of share-based incentive schemes and imposing (initially) modest performance requirements. The interplay of the Greenbury and Hampel reports and the developing ABI Guidelines can be followed through what have now become annual revisions. It can clearly be seen that step by step the remuneration committee is asked to take increasing responsibility for ensuring that the executive reward structure is aligned with the overall business strategy of the company. Thus,

“ Boards should demonstrate that performance based remuneration arrangements are clearly aligned with business strategy and objectives and are regularly reviewed. They should ensure that overall arrangements are prudent, well communicated, incentivise effectively and recognise shareholder expectations.

It is particularly important that remuneration committees should bring independent thought and scrutiny to the development and review process together with an understanding of the drivers of the business which contribute to shareholder value.” ABI (2005, p3)

There are additional requirements as to how the performance metrics in the pay-for-performance relationship should be chosen to align with the company’s key performance indicators and that the calibration of reward to performance metrics is expected to be such as to mark the relative importance of these indicators. Not only is this choice and calibration by the remuneration committee to be judged in the light of the company’s business strategy but choices are to be re-visited in order to confirm that the original choices are continuing to deliver in a way that is consonant with the company’s contemporaneous situation and the evolving views of shareholders. This pressures the remuneration committee to keep in view both the previously awarded incentive schemes and the current design of incentive schemes. The advisory vote, introduced by the Directors Remuneration Report Regulations (2002), ensures that the remuneration committee remains under annual pressure to deliver on these expectations.

This is, of course, no more than would be suggested by any strategic human resource management text book (e.g., Baron and Kreps, 2000), but there is an important shift taking place here. Whereas remuneration committees were once merely seen as an arms-length administrative device to ensure an acceptable degree of probity in the setting of executive reward, things have now changed substantially. Remuneration committees are now seen as key agents in the process of choosing a remuneration package, arranging that it is calibrated in a way that ensures the incentives faced by the executive directors are such as to incentivise the executive towards those decisions and actions necessary to best deliver the company's chosen strategy. In so doing, there is also an expectation that the remuneration committee will periodically confirm that the extant bonus schemes, performance share plans, and share options are in effect operating in accord with the company's current needs.

The remuneration committee finds itself tasked with a prime responsibility of remedying or ameliorating the principal agent problem of incentive alignment for members of the top management team (Jensen and Meckling, 1976). This is a key role in the strategic human resource management of the company. On top of this, of course, there is a requirement that the remuneration committee communicate effectively to the shareholders with regard to all the above.

This is a big 'ask', and it is our hypothesis that current remuneration committee practice is not sufficient to deliver on these particular high expectations. The following section of the paper draws on some new interview data to examine how effective remuneration committees are in living up to the expectations placed upon them.

Observed gaps between outcomes and expectations

Pettigrew and McNulty (1995) observe that because much discussion of corporate governance in the UK has focused on rules, regulations and structures (all easily observable) it has overlooked the important reality of boardroom power and influence, without which it is difficult to comprehend boardroom dynamics and director

effectiveness. Landmark studies of the pay performance relationship in executive reward, from the Jensen and Murphy (1990) to Hall and Liebman (1998), Conyon and Murphy (2000), and Hall and Murphy (2002), are all guilty of this oversight. Recent interview-based studies of boardroom processes have set out to remedy this shortcoming. Although much of this work has addressed issues concerning the entire board (Pettigrew (1992), Pettigrew and McNulty (1995), Stiles and Taylor (2000), Pye (2002), Pye and Pettigrew (2005), Roberts et al. (2005) and McNulty et al. (2005)), there have been a handful of studies specifically examining remuneration committees⁹ (Bender (2003, 2004, 2007), Ogden and Watson (2004), Perkins and Hendry (2005), and Lincoln et al. (2006)) and it is upon these that the current investigation builds.

The findings presented below are based on interviews conducted between 22 September and 15 November 2006. A total of 22 independent non-executive directors each with current experience of remuneration committee service were interviewed regarding their experience of remuneration process. The semi-structured interviews lasted between 60 and 90 minutes. The interviews were not taped, but a dedicated note-taker was always present and a transcription of the interview subsequently produced¹⁰. Respondents were currently serving on a total of 68 boards, and on 33 of these they were members of the remuneration committee. The remainder of the paper considers the evidence gathered on the remuneration process in the course of these interviews. We focus on four key activities of the remuneration committee: the remuneration determination process (membership, meetings etc); establishing the components of remuneration (through design of plans and construction of performance measures and targets); review of the remuneration design (by scrutinising how the remuneration package is working in practice); and communicating with the various stakeholders. The key research question investigated is: to what extent do remuneration committees behave in a way that is consistent with current expectations?

⁹ In an early study, Main (1993) conducted interviews between October 1992 and April 1993 on the director remuneration process at 24 large UK companies. And, in 1999, Conyon et al. (2000) interviewed directors at eight UK companies.

¹⁰ Practice varies as to the use of tape recording. Bender (2003, 2004, 2007) and Ogden and Watson (2004) both taped their interviews, while Perkins and Hendry (2005) and Lincoln et al. (2006) relied on note taking and subsequent transcription of these notes.

The remuneration determination process:

Table 1 is based on data taken from the most recently published annual reports of the companies on whose remuneration committees the interviewees served and reveals an average of 4.8 remuneration committee meetings per year, not too different from the average number of audit committee meetings. Respondents recall these meetings lasting an average of 1.5 hours¹¹. Consistent with this data, interviewees did not report the workload of the ordinary remuneration committee member to feel onerous.¹²

Table 1 about here

In addition to the actual frequency and duration of meetings, scheduling is a potentially important consideration – whether on a separate day from the Board, coming before, or following after the Board. In all but three cases, committee meetings were reported to be slotted around the main Board meetings, but this was not generally seen as a factor that reduced the effectiveness of the committee, being taken as an unavoidable logistical consequence. The tight scheduling of committee meetings and relatively brief meetings did, however, lead to feelings of frustration:

“The committee did not spend as much time as it should have done. Wish it had been two hours not one hour. I wish I’d have more time to read papers and interrogate as oppose to philosophical discussions.”

Lincoln et al. (2006), who focused¹³ on some of the more practical aspects of the remuneration committee’s operation, suggest that recruitment to the remuneration

¹¹ With an additional 2.8 hours on average of preparation.

¹² Windram and Song (2004) report that in 2000 audit committees among the UK’s largest companies were meeting on average 3.3 times per year with each meeting lasting 2 hours on average (range 0.67 to 4 hours) and preparation time averaging 5 hours (with a range 3 to 16 hours). This data is pre-IFRS reforms and may understate the current situation.

¹³ Lincoln et al. (2006), a ‘Parc’ study, involved conversations with 28 people, including Remco members and HR executives from 19 large companies (FTSE20 or US-listed). Remuneration consultants, academics, search consultants and representatives of the ABI and NAPF comprised the others.

committee is not the highest priority in the allocation of boardroom talent¹⁴. When we probed as to the detail of which directors sat on the remuneration committee, respondents indicated that membership was either a result of sharing out the committee workload across independent directors or a result of a company convention that all independent directors sat on the committee. There was no sense in which the remuneration committee was seen as a residual claimant on the talent of the independent directors (e.g., second to the audit committee). Membership itself was generally seen as requiring general skills rather than any particular expertise in human resources:

“Specialist knowledge is helpful although common sense and judgement is most essential.”

That said, communication and liaison with the audit committee was recognised as important. To illustrate this point, one respondent recounted how an inconsistent definition of earnings per share had caused problems:

“We nearly let something slip through because of a lack of communication between the audit committee and the remuneration committee – so the chair of the audit committee was put on the remuneration committee.”

Although the Combined Code clearly envisages the remuneration committee to be a body of independent directors, our interviews revealed that, in reality, most committees actively engage the executives in the remuneration design and determination process. Indeed, the attendance of the chairman and the CEO was generally taken for granted, save at times when their own remuneration was under discussion, and the recent change in the Combined Code (2006) that permits the chairman to be a member of the remuneration committee¹⁵ was welcomed. While an input from the executive was seen as essential, and allowing that in a few cases committees had standing arrangements for an ‘executive-free’ part of each meeting, the involvement of executives could be a source of conflict:

¹⁴ Lincoln et al. (2006, p16) extend this observation beyond mere selection for committee service to a lack of induction or development training received for this function. The companies in the Lincoln et al. (2006) study came primarily from the top of the FTSE100, whereas the companies in our study are more widely spread throughout the FTSE250.

¹⁵ Until the 20 June 2006 revision of the Combined Code, the chairman was not permitted to be a member of the remuneration committee.

“It’s more inhibited when they’re there.”

Which could be stronger, as in:

“We probably erred by having the CEO and chair there almost all of the time.”

But, inhibiting or not, the input of the executives’ perspective was seen as essential, although the involvement of executives in the remuneration process often went beyond information gathering. For some, the process of choosing the structure of the remuneration arrangements had distinct aspects of negotiation about it. The negotiation could be incidental:

“For the direct reports of the CEO, he must have some say, although it does tend to set the framework for his own expectations.”

Or tacit:

“He claimed he wanted the team to benefit but, when it got down to it, he was the only one in the team.”

Or plain explicit:

“Life is one long negotiation with our chief executive. We have a thrusting, dynamic young man who has thrusting, dynamic ideas of remuneration.”

And it may depend on the personalities involved and the culture of the company:

“Some companies have a lot of ‘push-up’. Others are more quiescent.”

But it is generally accepted that to set appropriate incentives it is necessary to have a sense for what will work¹⁶, and in this respect the view of the CEO was essential in determining whether a particular design was one which promoted the desired behaviour by the executives:

¹⁶ Just as anyone fishing soon knows that tying a fly on one’s line just because it looks pretty rather than taking the fish’s perspective is a recipe for failure.

“It’s quite normal for the chief executive to say ‘I feel strongly that X should be in there’. As a remco member I was quite keen on this enthusiasm, getting their buy-in.”

One finding of our research that appears to have previously been overlooked is the key role played by the chairman of the remuneration committee. In establishing the appropriate relationship on remuneration with the senior executives, the remuneration committee chair was seen to be the key player:

“The really mendacious chief executive is one thing we haven’t discussed. That’s a real challenge. You get different types of people. With a very difficult chief executive, the ultimate discussion is between the chair of the remuneration committee and the chairman.”

And,

“In one situation, the chair of a remuneration committee looks to me... ‘When we’ve taken a decision, we have taken a decision and do not accept pushback’. The strength of the remuneration committee chairman is important. As long as you are within the parameters of the benchmarking and company policy (e.g. median) most chairs of remuneration committees are quite tough. You need to have been around a bit to be chairman of a remuneration committee.”

The chair of the remuneration committee also plays a major role in dealing with the various constituencies – both in terms of ‘negotiating’ with the senior management and in terms of liaising with the remuneration consultants and the internal human resources/ compensation and benefits staff function in the company. This makes the chairman role a relatively onerous one, both in terms of time and also in shaping the agenda and key proposals put before the committee. As one remuneration committee chair noted in terms of managing the flow of information to the committee:

“It’s important to come with not necessarily a fully-baked cake but you need to know if it’s a fruitcake or a sponge cake and of what shape.”

The committee members we interviewed invariably made reference to the part consultants play in the process, both in provision of information (e.g., market data) and in forwarding ideas on design. However, remuneration committee chairs, in

particular, also suggested that the HR director (or top reward specialist) also played a vital role in supporting the process.

The important dimensions emerging above are that the remuneration committee is seen as a generalist committee. With the exception of the chair, its meetings are not felt to be particularly time consuming, although, as we shall reinforce below, there is a sense in which longer meetings might prove useful. The committee finds itself negotiating (implicitly or explicitly) with the executive team regarding the shape and size of their remuneration packages. In all of this, the chair of the committee is seen to play a key role. Many of the remuneration committee members interviewed felt that prior or current involvement in more than one remuneration committee was essential preparation for taking the committee chair role.

Having discussed our findings on those who make the remuneration decisions and how they operate, we now turn to examine how the detail of remuneration design.

Establishing the components of remuneration:

When it comes to choosing the pay elements and their links to performance, interviewees recorded a range of opinion, with no small number being quite simply sceptical of the efficacy of the process. This ranges from those who do not regard executives as being driven by such extrinsic rewards (Fehr and List, 2004):

“This motivational business is “phooey”. People do the best job they can. Our LTIP is based on the TSR of a comparator group. You’ve no idea until the end of the three years what the outcome will be. So what can you do? People just do their best.”

or, more directly:

“I suspect it’s not an incentive. The simpler the scheme, the more of an incentive it is...”

and:

“If it takes a reward to get him (CEO) to work then he is the wrong guy.”

to those who suspect the process is incapable of being designed properly to motivate but should at least take care not to de-motivate and, in particular, to result in a defensible level of payout:

“One wonders at the end of the day if it motivates but you have to make sure that it doesn’t de-motivate. The company itself should be protected – paying sensible figures for sensible results.”

One driving consideration in choosing the remuneration package was how it would appear to institutional shareholders and other outsiders (Bender, 2004), as the following views from three different executives make clear:

“We look at the maxing-out amounts. This is what you have to do for the institutions.”

“How is this going to look in the annual report when the institutions crawl over it?”

“..we have the whole mechanism for not rewarding failure rather than seeking to get a genuine incentive.”

In their interviews of board committee members¹⁷, Spira and Bender (2004) bring out clearly this tension that exists within the remuneration committee between ‘Performance’ on the one hand (achieving an effective principal-agent type pay mechanism, thereby strategically aligning incentives) and what they label ‘Conformance’ on the other. With ‘Conformance’ the emphasis is very much on being able to demonstrate in an ex-post sense that pay awards conform with the various governance codes reviewed above, i.e. monitoring. The ‘Performance’ versus ‘Conformance’ distinction echoes the observation with which Hampel (1998, para 1.1) opens his report, namely that effective governance makes a contribution both in terms of ‘accountability’ but also in terms of ‘business prosperity’, and that a preoccupation with the former can be to the detriment of the latter.

¹⁷ The Bender project interviewed [December 2001-May 2003] some 35 people involved in the executive reward process: 20 board directors, 3 company secretaries, and 12 HR professionals at 12 companies – including nine FTSE100. See also: Bender and Moir (2006) and Bender (2003, 2004, 2007).

In the pursuit of conformance the remuneration committee is mainly concerned with probity, whereby the independent directors monitor the executive pay process on behalf of the shareholders. Performance considerations, on the other hand, are more managerial and entail the remuneration committee actively designing remuneration arrangements that both connect with the external reality of the executive labour market (in paying the going rate) and aligning the interests of the executives with the achievement of the key success factors that underpin corporate strategy.

In terms of performance, the remuneration committee performs a key role in the strategic human resource management of the company by crafting remuneration arrangements that attempt to link the interests of the top management team with attainment of the key success factors for corporate strategic success (Stredwick, 2000). From the quotations above, there is obviously a clear tension between the this performance role and the conformance role. In a series of interviews¹⁸ with remuneration committees of water companies, Ogden and Watson (2004, 2006) also conclude that remuneration committees feel highly constrained by political considerations. Such institutional pressures are seen to result in DiMaggio and Powell's (1983) isomorphism in organizational practice, whereby the desire to shape remuneration design in a similar manner to other comparable companies dominates detailed considerations of performance effects.

In our interviews, evidence of a similar desire to conform also emerged when remuneration committee members attempted to explain the relative prevalence of growth in earnings per share (eps) and total shareholder return (tsr) as performance metrics in long term incentive awards. The requirement to satisfy outside commentators rather than any linkage to corporate strategy was usually proffered as a justification. From three different interviews:

“[We] used eps due to the lack of anything else we could think was acceptable. We knew the market would be comfortable with eps and we were unsure as to which one [metric] we should be using.”

¹⁸ Ogden and Watson (2004) focused on five water companies, covering some 25 individuals including members of remuneration committees, CEOs and senior HR professionals servicing the remuneration committee.

“The obvious metrics of eps and tsr are catch-alls but it’s where you always end up.”

“Normally I am happy to put my head over the parapet but not in remuneration. I would be slightly cautious as I don’t want to be castrated by the ABI.”

Some remuneration committee members expressed a frustration at the lack of depth of the analysis in the contribution made by the committee to the design of the remuneration package:

“There is not enough brainstorming in our case”.

And those who suspect the remuneration committee is not successful in how it designs the incentives:

“I’m doubtful how incentivising the package is. I think at least once a year we ought to have a fairly open-ended discussion and not too strictly bound by time. I feel the need to have a more strategic meeting: What are we trying to achieve? Is the system too complicated? Is it alright?”

There was particular concern expressed regarding the long term incentive (LTI). Whereas most were satisfied that their performance metrics operating on the short term incentive (STI - annual bonus) spoke directly to the company’s strategic requirements, there was considerable unease with regard to the LTI. Thus:

“Everyone understands the short-term plan but long-term is an area where executives don’t understand the reward.”

“I have often found it difficult to see how management conduct and performance has been affected/influenced by LTI.”

“Complex publicly traded companies have diffuse goals and incentivising people in that multi-dimensional world is not getting any better.”

This sharp break between STI and LTI can be seen in Table 2. The performance metrics utilised in the companies where the interviewees sat on the remuneration committee reveal a much richer range in STI (annual bonus) than in LTI (share

options and performance shares). There was a sense in which remuneration committee members were more at ease with STI and found it easier to relate those performance measures and targets to the top management team.

In their study of remuneration committees, Perkins and Hendry (2005) made an explicit attempt to examine the extent to which remuneration committees¹⁹ really adhere to the principal-agent vision of designing a remuneration package that provides incentives calibrated in the light both of what labour market forces indicate and what corporate strategy requires. An important conclusion of their work is the recognition of the wide range of discretion afforded the remuneration committee in its deliberations (“space for interpretation”, p1446) and that “what matters is how rewards appear, not whether performance is being objectively over-valued” (p1464). The result is that “Ordering top pay may then prove to be contingent more on ‘communication’ than performance management considerations.” (p1464). Again, the dimension of conformance dominates performance considerations and this is confirmed in our findings in terms of LTI design.

Table 2 about here

But, as in the findings discussed above, remuneration committee members also expressed frustration at the difficulty they confronted in ‘validating’ (Perkins and Hendry, 2005, p1457) the pay-performance relationship set in place, e.g., in terms of the appropriateness of the chosen comparator companies in long term plans, or the robustness of the targets in short term plans. We shall refer to this as the calibration process and, in a world of fast changing and noisy data, it presents the committee with a serious challenge but one that must be confronted if it is to live up to the ‘performance’ expectation now placed upon it, in the sense of effecting an alignment of the interests of the top management team with the successful implementation of the company’s strategy.

¹⁹ They interviewed seven people who, among them, had sat on 20 remuneration committees. Five search consultants were also interviewed in the Perkins and Hendry (2005) study.

It is noteworthy that although the calibration process lies at the heart of principal-agent theory, Perkins and Hendry (2005) conclude that the principal-agent perspective provides a wholly distorted vision of what actually occurs in remuneration committees and boardrooms. As with Bender (2003, 2004, 2007), they emphasise the empirical impact of wider social processes on the decisions of the remuneration committee and reject the view that remuneration packages are precisely calibrated to reflect labour market conditions. This again points to an isomorphism in organizational practice. Of course the main confounding factor in terms of organisational isomorphism is social learning (Westphal et al., 2001) which can be observationally equivalent. An eloquent expression of this arose in our interviews:

“My view is “follow with pride”. You need to keep standards up re: techniques and ways of reporting. Copying ideas from other companies is a good thing if they are appropriate. Actively looking outside to see what developments there are. If there’s been a major issue elsewhere then pause for thought Why did that happen? Could it happen to us?”

While social learning may play a part in the story, the bulk of the evidence presented above calls into question the extent to which remuneration arrangements are designed to attune the interest of the executives to delivering corporate success. The following subsection extends this line of analysis by probing as to the extent to which remuneration committees re-visit earlier decisions in the context of recent experience and their current strategy agenda – the confirming of the remuneration design.

Review of remuneration outcomes:

Given the lack of confidence generally expressed regarding the effectiveness of the design process, particularly in terms of the LTI, it is all the more surprising how little account our respondents took of the extant grants of long term incentives held by the executives in terms of deferred bonus, share options, performance share plans and so on. Any judgement regarding the precision of the alignment of interests between the top management team and the attainment of corporate strategy must rest, to no small extent, on whether previous incentive grants are currently ‘live’ in the sense of being likely to pay out, and the impact that they are having on current executive behaviours.

Core et al. (2005, p1169) labels this distinction between the annual award and the total situation of the executive as one between ‘Pay Incentives’ and ‘Portfolio Incentives’²⁰.

For short term incentives, monthly information arising out of the regular budget monitoring process was often used to keep sight of likely annual bonus outcomes. However, it was extremely rare to find much effort being made in the remuneration committee to review the long term incentives faced by an executive and, in many cases, surprisingly little was done to appraise executives of how they were faring in terms of likely payout of earlier issues of LTIs. Prior to 2002, it was common to find both retesting of performance targets and payouts on performance share plans for below median performance but, owing to institutional pressure, these features are now largely absent. As a result, long term incentives have become a much more fragile vehicles for delivering performance–related remuneration. This makes the failure to monitor and revisit past long term incentive grants all the more surprising, particularly when coupled with a recognition that the LTI is often not well understood by the recipients and remuneration committees:

“.. executives could not see what they had to do to impact on reward.”

“They never know from one month to the next if they are in the money or out of the money. There’s no line of sight”.

Although there are, as usual, exceptions to this situation:

“We produce a valuation once a year and we write a note saying ‘you can’t rely on this but this is what’s happening at the moment’ ”.

Of course, bounded rationality and imperfect information ensure that outcomes may not be as expected - due to poorly chosen comparator groups, performance metrics, or performance targets, a situation possibly made worse due to unexpected changes in the company’s environment. The evidence from our interviews suggests that with STI the problem is less likely to arise, owing to more carefully selected metrics with more accurate calibration (one year horizon as opposed to three years with LTI). The

²⁰ Main, Bruce and Buck (1996) use data from the Register of Directors’ Interests to illustrate the empirical significance of the latter.

remuneration committee seems more ready to exercise discretion on STI when things do go adrift. With LTI, on the other hand, the metrics are more standardised and the calibration more constrained and difficult under a three year horizon.

A key question is whether, mindful of the participation constraint²¹, the remuneration committee is ever prepared to exercise discretion in adjusting the payout or the design of the incentive schemes. Bender (2007) presents evidence to suggest that, in such circumstances, companies re-design their incentive schemes to better effect a pay out. In many ways this is an unavoidable consequence of the fact that shareholder approval has been sought for the design of share-based LTI schemes and with boardroom executives usually operating at the maximum limits permitted under such schemes there is little scope for discretion. A shareholder vote is then required to change the long term incentive. In any case, discretion is something that the remuneration committee member wishes to avoid.

“We’d like to use discretion as little as possible.”

“ .. we try to take discretion out.”

“Rules are rules.”

“It’s silly to design a plan and get it approved by shareholders and then go back next year regarding changes.”

When the LTI scheme is seen to fail then the general reaction is to hold a review and re-design the scheme (see Bender, 2007) or, in rarer cases:

“Change the people rather than change incentives.
Incentives only work so far”.

Lincoln et al. (2006) also highlight the attention (in both time allocated and effort expended) given by remuneration committees to the pay for performance relationship. It requires detailed scrutiny (and re-scrutiny) of the performance of the company and

²¹ Whatever the incentive aspects of the contract, the executive must see in it an expected value that is at least as high as is available in an alternative employment, otherwise they will not participate in the offered contract (Gibbons, 2005).

the performance of the executives²². Rather than probe deeply on this issue, it is easy for a remuneration committee to fall back on an isomorphism of organisational practice and do what everyone else is doing – for example, by setting relative TSR targets for the vesting of options or performance shares, deferring STI bonus payments into unvested equity, and so on²³. While the award of any package may be tested against ‘overpayment’ to minimise the risk of incurring Bebchuk and Fried’s (2002) “outrage costs”, the time and resource may not be available to allow a rigorous investigation of just which performance targets best ‘fit’ the company’s overall corporate strategy or reflect the existing tranches of options, performance shares, unvested bonus payments and accrued pension entitlement already awarded to the executive in question.

The willingness on the part of the remuneration committee to confirm the efficacy of the chosen reward mechanisms is of critical importance in the dynamics of executive reward²⁴. Key to this view is the notion that companies regularly confirm that the reward mechanisms in place are performing as required. One inhibiting factor in confirming the efficacy of the remuneration design and adjusting it in the light of that information is the need to communicate with shareholders. It is to this final aspect in the roundel of remuneration committee activity that we now turn.

Communicating with stakeholders:

In terms of communication, there was a remarkably robust attitude displayed by most respondents towards communicating with shareholders. This may reflect the fact that

²² One extension of this analysis is into an evaluation of how the remuneration committee actually dispatches its duties or fulfils its terms of reference. This is thoughtfully examined in Likierman (2006).

²³ Greenbury (1995) declared that on performance share plans – “...schemes along these lines may be as effective, or more so, than improved share option schemes in linking rewards to performance” and from literally nowhere the use of performance share plans in the FTSE100 had risen to 84% by 2005. The same report also declared that “Consideration should be given to criteria which reflect the company’s performance relative to a group of comparator companies in some key variables such as shareholder return (TSR)”, and by 2005 some 86% in of performance companies in some key variables such as shareholder return (TSR)”, and by 2005 some 86% in of performance share plans used relative TSR. See Booker and Wright (2006). Some breaking of ranks has been visible lately, with the performance share plans utilising operating margin (BA in 2005), sales growth (Sainsbury in 2005), and ROCE and cash flow (Sainsbury in 2006).

²⁴ This movement back to the optimum pay-performance sensitivity lies at the heart of principal-agent theory is, according to Core and Larcker (2002), the only generally available insight into the causal connection between pay and performance. Key to this view is the notion that companies regularly confirm that the reward mechanisms in place are performing as required.

having made every effort to conform there was little to fear from institutional criticism. Specifically, in terms of the ABI:

“I go and talk to them and they turn out to be pretty sensible.”

Most of those who contact their shareholders or institutional representatives such as the ABI are prepared to make concessions:

“.. gave in to the ABI too easily last time.”

“We were prepared to concede a higher target. We had further concessions in the locker that we didn’t have to give.”

Much rarer (unique in our study) are those prepared to endure the sanction of a poor rating from the ABI:

“If you don’t get a certain number of amber tops then you are not looking after the people!”

If anything, it is in communication with the executive team where the remuneration committee experiences most tensions:

“A triangular relationship with the company chairman is the best structure - including the remuneration committee and outside advisers. The relationship between the remuneration committee chairman and the chief executive and executive team (business objectives, decision to be median or upper quartile payers,). Lack of engagement between remuneration committee chair and executives is a big problem if it occurs. That’s where the delicate balance is.”

“I get a sense that directors are becoming rather irritated by being boxed in. They want us to go and see the ABI etc., tell them what we’re doing and put up with the flack.”

“Executives, the ABI, shareholders: there’s no alignment of interest. Standing back now after 10 years as a remco chairman – you’re lashed to different sets of horses and being pulled apart.”

This tension is illustrated in Figure 1 and probably represents the major tension in the remuneration committee. From the evidence above and that of Bender and Spira (2004) and Bender (2003, 2004, 2007) it is the dialogue outside of the company that currently influences most remuneration committee behaviour.

Figure 1 about here

These tensions can be a manifestation of the remuneration committee doing a good job, by designing remuneration arrangements that are both effective and challenging. But they can also be a sign that owing to external pressures an incentive scheme is imposed that does not offer an effective line of sight between reward and achievement of the critical success factors of the company's business strategy.

5. Conclusion and policy discussion

The changes in the corporate governance environment since Cadbury (1992) have led to increased expectations regarding how remuneration committees should operate. Some of these expectations refer to structure and have, by and large, been universally adopted. Other expectations refer more to the conduct and objectives of the remuneration committee, and represent a serious demand on its capacity. Principal agent theory suggests a pay-for-performance reward mechanism is a possible answer to the bounded rationality (Simon, 1947), opportunism and information impactedness (Williamson et al., 1975) problems that beset the effective management of the executive directors. Institutional investors and the ABI, in particular, have made it clear that their expectation is that it falls to the remuneration committee to design and implement such a reward mechanism in a way that is in tune with attainment of overall corporate strategy, and to design employment contracts and remuneration arrangements which avoid risk of 'reward for failure'.

However, the challenge facing the remuneration committee is to choose reward devices and to calibrate them in a way that aligns the interests of the executive directors with the accomplishment of the key success factors necessary for the delivery of corporate success. To do this, of course, there must be clear line of sight between the directors' actions and reward delivery. Far from being a one-off

decision, such are the vagaries of the global economy and the competitive business environment that these reward mechanisms require regular review as to whether they continue to be appropriate. Finally, the remuneration committee needs to communicate meaningfully with both shareholders and with the executive directors concerned as to how it has arrived at its decisions.

But the remuneration committee is not an independent ‘black box’. As with the board itself, it is a social construct. It is necessary, therefore, to recognise the cognitive limitations arising out of the finite information, bounded computational capacity and restricted time that confront the remuneration committee. At any time, the prevailing remuneration arrangements may depart from what might have been suggested with the benefit of full information and a full understanding of the situation about to unfold. Our findings confirm those of previous researchers in the field, namely that based on current practice it is difficult to see the remuneration committee as being guided solely by principal agent theory. Confronted with a desire to do the right thing and the need to be accountable for the outcome of their decisions, remuneration committees reach for the security of the institutional isomorphism and set in place remuneration arrangements that look very similar to those of their neighbours.

In particular, we find that the organisation of a successful remuneration committee depends on more than simply drafting a requisite number of independent directors as members. The remuneration committee chair plays a key (and time consuming) role in managing and coordinating the remuneration committee, the top management team, the external advisors and the internal human resources staff to achieve an acceptable outcome for all stakeholders. This role has probably been underestimated and undervalued to date.

In determining the remuneration arrangements, the committee’s work extends beyond that of adding probity to the process to a much more important managerial task of aligning the interests of the top management team with the critical success factors vital to the company’s business strategy. One interviewee reported taking the remuneration committee on ‘away days’ so that they could focus on this challenging task. The overwhelming majority did not appear to engage on that level of detail, and the rather homogeneous metrics utilised in their LTI enforced this conclusion.

There was relatively little emphasis on focusing the remuneration committee on reward outcomes built up over years through a succession of base salary, bonus, long term incentive and pension policies. Each year's reward tended to be treated on its own as a separate event rather than as the opportunity to 'rebalance' the executives in the light of recent developments. To an extent, this was due to rigidities inherent in having to seek shareholder approval for changes in the LTI but it was also due to a reluctance to revisit past designs and recalibrate them to reflect current realities.

Communication with shareholders and institutions such as the ABI tended to be of more concern to remuneration committees than communication with the top management team. This leads to tensions with senior management with whom an often overlooked ongoing negotiation (albeit tacit) must take place.

In terms of policy recommendations, it would appear that attention should be paid to the critical role of remuneration committee chair. An increased allocation of time (either in duration or frequency of meetings) seems to be merited if the technical aspects of calibrating the LTI with the key success factors of the company's business strategy are to be addressed. An effort needs to be made to examine the entire portfolio of unvested and vested-but-unexercised executive reward while considering the composition of the latest year's award. The discretion to fine tune the award package in the light of current circumstances will depend on a willingness to build such flexibility into the design of approved LTI schemes and an acceptance of responsibility for such actions. Similarly, in communicating with the ABI and other institutions, a more explicit readiness to accept responsibility for the reward scheme set in place (and its implementation) would improve effective communication.

Current choices of remuneration committees are strongly constrained by an institutional isomorphism in practice. Expectations that the remuneration committee is mitigating the principal agent problem by crafting appropriately designed reward mechanisms are over optimistic. If there is to be a movement in this direction it will require considerable change in remuneration committee practice.

The evidence gathered in this study suggests that structural considerations (who serves, etc.) for remuneration committees are now secondary in importance to procedural and resourcing considerations (how the business is done). Remuneration committees feel constrained in their choice in terms of remuneration design, particularly with regard to LTIs. They commonly fail to allocate the time or resource to oversee the effective operation of the chosen remuneration plans and many of their actions are dominated by a perceived need to be able to justify any high pay outcomes in communications with shareholders and institutional investors. We are therefore left with the possibility that the way in which remuneration committees currently conduct their business limits the extent to which they are able to live up to the high expectations placed upon them in terms of effecting an alignment of executive interests with the critical success factors of corporate strategy.

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Table 1

Characteristics of Respondents' Remuneration Committees

	Average	Median	Min	Max
Remco members	3.9	4	2	6
Audit Co. members	3.7	4	3	5
Nom Co. members	4.6	5	2	8
Remco meetings per year	4.8	5	1	9
Audit Co. meetings per year	4.4	4	3	12
Nom Co. meetings per year	2.5	2	1	6
Length of Remco meeting (hours)	1.54	1.50	1.00	2.50

Membership and meetings data is taken from the remuneration reports of the 27 LSE companies on whose remuneration committees the respondents sat. Length of meeting data is averaged over all respondents' recollections.

Table 2: Relative use of performance metrics across schemes

(i) Performance metrics utilised
in annual bonus schemes

	Number of schemes using this metric	% schemes using this metric
profit	16	59%
earnings per share	9	33%
personal targets	8	30%
free cash flow	4	15%
sales	3	11%
return on capital employed	2	7%
other accounting metric	2	7%
customer satisfaction	2	7%
total shareholder return	2	7%
return on equity	1	4%
budget	1	4%
property price index	1	4%
net asset value per share	1	4%
costs	1	4%
debt reduction	1	4%
reportable injuries per thousand employees	1	4%

(ii) Performance metrics utilised
in share option schemes

	Number of schemes using this metric	% schemes using this metric
earnings per share growth at retail price index +x%	7	78%
relative total shareholder return	1	11%
other	1	11%

(iii) Performance metrics utilised in
performance share schemes

	Number of schemes using this metric	% schemes using this metric
relative total shareholder return	19	90%
earnings per share growth at retail price index +x%	8	38%
cash flow	1	5%
return on invested capital	1	5%
net asset value per share	1	5%
profit	1	5%
other	1	5%

Source: data from the Directors Remuneration Reports of the LSE companies on whose remuneration committees the respondents sat

Figure 1

Representation of remuneration committee relationships

