4 Research review on director pay

Members of the board of directors are charged with setting executive pay, and the way they compensate themselves may provide valuable information for understanding executive compensation (Yermack, 2004; Ryan and Wiggins, 2004) and other firm outcomes. Research on director pay is still in its infancy. Compared to the vast amount of research conducted on executive pay, academics have long shown relatively little interest in understanding how non-executive board members are getting paid and what effects their compensation has on the firm.

4.1 Directors as the shareholders' agents

The lack of interest in director pay may partially be explained by the assumption of agency theory and optimal contracting theory that the board of directors and the compensation committee act in shareholders' interest. Optimal contracting theory assumes that there is no principal-agent relationship between (outside) shareholders and the board of directors. Consequently, there are no agency costs between shareholders and board members and incentive compensation is irrelevant. The main research topic in executive pay – the pay-performance relationship – is not relevant in the area of director pay. Not surprisingly, Yermack (2004) documents that the pay-performance sensitivity of outside board members is several orders of magnitude lower than that of CEOs. Consistent with executive pay results (e.g. Jensen and Murphy, 1990a), most of this sensitivity stems from changes in the value of shares and option holdings. The pay-performance sensitivity arising from annual changes in cash pay and equity-awards is extremely small. Yermack (2004) also shows that the incentives of each director will generally increase over his tenure due to an accumulation of equity-based retainer awards.

Assuming that there is no principal-agent relationship between shareholders and board members is an unsatisfactory simplification. Directors are charged with the responsibility of managing and supervising the business and affairs of a corporation on behalf of shareholders. They are responsible for hiring, firing, evaluating, and monitoring the top management team. Thus, directors themselves are the shareholders' agents and their conflicting preferences may give rise to agency costs. Incentive

compensation may also help align the interests of directors and shareholders. Paying directors with stock or options will force board members to recognize that their decisions will not only affect their own wealth but also the wealth of shareholders (Jensen, 1993; Shen, 2005).

Director pay may have important effects on executive pay. Schmid (1997) suggests that outside directors without share ownership would not represent shareholders and their interests. Similarly, Hermalin and Weisbach (1998) determine a model of boards that suggests requiring incentive pay for directors could lead to greater monitoring. In situations of higher director equity pay, the monitoring-substitution perspective proposes a smaller need for *executive* incentive compensation.[11] Acknowledging these issues, researchers now have increasingly become interested in the compensation of non-executive directors.

4.2 Overview of outside director compensation

Yermack (2004) provides an overview of director compensation in the US. Outside directors are usually paid a fixed annual retainer (and smaller additional fees for full board and committee meeting attendance). For the majority of directors, compensation is not tied to the success of the firm or their individual performance in the boardroom. This is consistent with a traditional agency theoretic view judging the role of director incentive pay as negligible. Nevertheless, since the late 1980s an increasing number of companies have paid annual retainers at least partly in equity. And while the grant values of equity awards still exhibit little variation, their subsequent fluctuation has had the effect of tying directors' rewards more closely to firm performance than before.

4.3 Determinants and consequences of director compensation

Studies on the determinants of director compensation generally find that firm characteristics that explain executive compensation also explain director compensation. These findings are consistent with the notion that directors should be treated as agents of shareholders who need economic incentives to increase shareholder value. In an early

[11] Monitoring by outside board members of executive management replaces outcome-based executive equity compensation as a monitoring mechanism.