March 2005

Non-executive directors' fees

Two years after the Higgs review of corporate governance led to changes in the expectations of non-executive directors in UK-listed public companies is it time to question whether boards are any more effective today as a result?

One thing is certain: they are much more expensive than they were before the review. A report by Watson Wyatt, the pay consultants, late last year found that non-executive director fees had risen by 38 per cent in 2004 among those FTSE 100 companies that had reviewed their fees. The average fee at the time was £36,500, based on an average commitment of 18 days a year. But among those that had reviewed their board pay, the average fees had risen to £40,000 a year.

The findings were anticipated by an earlier survey of senior executives and non-executive directors in 51 of the FTSE 100 companies, carried out by Russell Reynolds Associates, the headhunting firm. It found that above-inflation pay rises for board members had been paid out in almost a third of those questioned.

When directors were asked to name the ideal annual salary level for a FTSE 100 non-executive director the most quoted figure was £50,000 between a range extending from £35,000 to as high as £100,000.

The danger of this kind of research is that it can become self-serving. With a few individual exceptions, I know of no job anywhere – from the office cleaner to the chief executive - where the people doing that job do not think they are worth more than they are paid.

The difference between office cleaners and members of a board is that the cleaners do not set their own pay rates or sit on committees with the people who do. Another difference is that, unlike boards, there is no vested interest among those presiding over the staffing bill to pay people any more than is necessary.

In fact parsimony is what passes for good management among those who are responsible for staff budgets. This message goes down the managerial line of most companies. But the reverse seems to apply in discussions about boardroom pay. It is as if the boardroom occupies some parallel universe where the normal laws governing working practices are reversed.

To understand the rigour – or lack of it - surrounding boardroom practices you need only look at some of the comments from that same Russell Reynolds report. The diversity of opinions suggests that these well-paid guardians of our top companies are uncertain about assessment practices, although they tend to be united on pay: most think they ought to get more.

Compare this small selection of views:

On pay: "It needs to go up, as the risks are greater these days," and "Clearly it will rise significantly," and "To get the quality you need to pay."

On appraisal: "Everyone marks everyone else," and "I just don't agree with marking colleagues."

On director's targets: "We go for collective targets. We stand together," and "[The] senior team must be a team in philosophy."

Almost four in five of those consulted thought that the pay of non-executive directors was not high enough. This seems extraordinary given that the role is a secondary job for many of them and that those who do this kind of job after retiring from an executive post will be using the income to supplement a pension.

There is no doubt that the job has grown more onerous for those who chair committees and the number of days devoted to a business for all non-executives appears to be rising.

The top paid non-executive job after that of the chairman is the chairmanship of the audit committee. Miles Broadbent, founder of the search firm, the Miles Partnership, says that the highest paid audit chairman he has handled was £120,000. That was in one of the big banks. "A lot of companies pay a £10,000 premium for the other committee heads," he says.

One issue emerging for companies whose executives are taking up non-executive jobs is the time spent on the external role although most seem to view this as a valuable way of comparing notes with other company behaviours.

"For full time executives, it is clear that taking no more than one non-executive role is normally appropriate. For those with solely non-executive roles, up to five or six is manageable," says Luke Meynell, head of the UK Board Practice at Russell Reynolds Associates.

This might suggest there are increasing numbers of openings for the kind of lay directors envisaged by Sir Derek Higgs. Not so. None of the recent reports on boardroom compensation has found any significant rise in the number of directors from anywhere other than senior executive roles or from those who have recently retired from senior roles.

Mr Broadbent admits that he keeps an eye out for retiring finance directors. "If you can get them positioned in an audit committee chairman's role while they are still fresh from their executive job it makes the ideal move," he says.

A recent international comparison, Korn/Ferry International's Annual Board of Directors Study that questioned nearly 1,000 directors in 14 countries, revealed a continuing steady rise in the number of women and ethnic minority directors in the past three years. This reflects a desire for greater diversity in the composition of big boards. But it does not extend beyond the familiar corporate club. The proportion of companies with academics on their boards showed no significant increase in the last four years.

Mr Meynell confirms the lack of interest in the recruitment of lay directors. "Bringing in such people is not proving easy," he says. "As the committee roles that each NED needs to fulfil become increasingly complex and structured, the role looks less and less one that people without specialist knowledge can take on. And certainly we find that people outside the traditional groups are not keen to take on the legal responsibility that comes with the job."

But are the legal fears overblown when directors' liability insurance is available for board members? There has been only one big negligence action in the US – against former directors of WorldCom – and one current negligence case in the UK - that of Equitable Life suing six of its former executive directors and nine former non-executive board members.

If changes in governance have been for the better why does the collective confidence of non-executive directors appear to have declined? Just over two years ago when Independent Remuneration Solutions, pay consultants, asked non-executives if they thought they had enough collective power to control a chairman or chief executive with a large stake in a company, some 82 per cent of them thought they had. But when the question was repeated earlier this year the percentage had dropped to 55 per cent.

The cost of compliance with the Higgs recommendations was an average of £820,000 a board in the UK, according to the Korn/Ferry report (and $5.1m per company in the US, on average, for compliance with the requirements of Sarbanes-Oxley governance rules).

Was it all worth it? Are big boards run any better today than they were in the past? Or are they just better paid? Where can investors seek future moderation in pay? Another review of corporate governance? Heaven forbid.