Directors' Pay – What's to be Done

John Hunter

It's open season on directors' pay again. Shock is expressed; moral outrage is voiced; the air is thick with heavy analysis, most of it wide of the mark; adverse votes are cast against resolutions with no connection to the real problem.

The situation is exemplified by recent affairs at BP. Chief Executive Bob Dudley was excoriated for being paid £14m. Shareholders voted against BP's pay policy (which was all they were empowered to do) as a means of expressing general unhappiness at Mr Dudley's remuneration.

Criticism of Dudley's pay came in a number of forms but can be boiled down to two: it was too large; and it should not have been going up when the BP share price was going down. The last of these reasons is wrong; the first is a matter of opinion with complex arguments for and against, none of which were expressed in any of the press coverage that I read.

Dealing with the last first, let us compare two fictitious companies at different stages in the business cycle. Both are oil majors of similar sizes. One – OilHappy – is cruising along on the tide of a rising oil price, making record profits each year that deliver strong cash flow sufficient to pay a rising dividend and maintain all existing operations, with some left over to make a few interesting investments in fashionable areas. The other – OilSad – is struggling with a collapse in the oil price, having to make hard choices about the future of its existing operations and its dividend, and unable to afford speculative investments which might nevertheless be important for its future.

Which CEO has the harder job? For which CEO would you (as beneficial owner) be most prepared to pay a premium for a quality leader? Which CEO is most deserving of reward? These are matters of opinion. If your answer to all three is 'OilHappy' then you are right to complain that Dudley's pay went up when OilHappy became OilSad. But I wouldn't think much of your judgement.

Others might argue for 'alignment'. This principle – that directors work better if their financial rewards are 'aligned' with those of beneficial owners – has become an act of faith in both pay policy and pay regulation. But there's no evidence to support it, indeed it's obviously not true. Does OilSad's CEO work better because his remuneration goes down when his job gets harder? Does the remuneration necessary to recruit or retain a good CEO go down in bad times, or up? Directors are not motivated like rats in a maze; nor does giving them exposure to the risks of equity investment have any relevance to how they do their jobs.

What of the criticism that Dudley's pay was 'too large'. Was there any analysis anywhere of the comparative remuneration levels of other oil major CEO's? That would give sensible commercial reasons for his pay, but if there was I didn't see it (and instinctively, given the prominence of US oil majors with US pay scales, we all know the answer). Was it too large relative to expectations when his remuneration package was awarded? Was it too large on social or ethical grounds? These are also metters of opinion, not debated in any press coverage that I saw. Nor was there any discussion of whether criticism should be directed at Dudley, at BP or at the system that produced it.

So what's to be done? Some would put their faith in attempting to relate senior pay to other metrics. The High Pay Centre's publicity for pay ratios is one example. There are many others. These are well-meaning, but in practice just invite further gaming of the system by remuneration consultants.

UKSA believes that the solution lies in the fundamental principles of good governance – meaning that the right people have a say over the right things. It's been our Manifesto for over six years:

- ***Directors contracts of employment should be approved by shareholders;***

- ***Remuneration consultants should be accountable to shareholders***

Also fundamental to all good corporate governance is that the word 'shareholders' should be defined to exclude intermediaries and include only beneficial owners, for which UKSA has been calling since it helped promote the private member's 'Protection of Shareholders Bill' in parliament in 2009 - and probably for a long time before that.

These changes, although obvious, are opposed by powerful interests and will take time. What can we do now? Well we can start by opposing *all* Long Term Incentive Plans (LTIPs). This has already been proposed by the voting advisory service 'Pensions & Investment Research Consultant' (known as PIRC). It is the arena where the gaming of the system takes place, not least because the convoluted reporting regulations allow the amounts to be concealed until it's too late. Perhaps we can hope for some re-think there also?

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