BRQ Business Research Quarterly (2017) 20, 79–95

BUSINESS RESEARCH QUARTERLY

www.elsevier.es/brq

REGULAR ARTICLE

Independent versus non-independent outside directors in European companies: Who has a say on CEO compensation?

Pablo de Andrés[a,*], Laura Arranz-Aperte[a,b], Juan Antonio Rodriguez-Sanz[c]

[a] *Autonoma University of Madrid, Spain*
[b] *Hanken School of Economics, Finland*
[c] *University of Valladolid, Spain*

Received 13 July 2016; accepted 20 February 2017
Available online 13 April 2017

JEL CLASSIFICATION
G30;
G34;
J30;
M52

KEYWORDS
Independent directors;
CEO compensation;
Board of directors;
Corporate governance;
European companies

Abstract Our study reveals how two separate dimensions of board composition—the proportion of independent directors and of non-independent directors—influence CEO compensation in Western European firms. Controlling for the simultaneous determination of CEO pay structure and board design, we find that firms with a higher proportion of non-independent outsiders on their boards pay less direct compensation (salary + bonus) and less equity-linked compensation to their CEOs. By contrast, CEOs working for firms with more independent boards receive more equity based-pay. When we control for the fact that equity linked is not granted systematically in Europe we find that firms with more independent directors on the board tend to grant equity-linked compensation more often than firms with more non independent outside directors. Our results challenge the commonly accepted view of independent directors as safeguards of shareholder value, uncovering the relevance of non-independent outsiders for pay moderation and incentives.

Introduction

Independent boards are considered optimal safeguards of shareholder value by closely monitoring the management team and by providing strategic advice and business contacts. Recommendations to increase the number of independent directors have been put in place both in the US and in Europe. Nevertheless, non-independent outside directors are numerous in public corporations, suggesting that although they might have a vested interest in extracting private rents from the firms of which they are board members, they can also add value to those firms. Despite a growing number of theoretical papers indicating the benefits of non-independent outside directors (Raheja, 2005;

* Corresponding author.
E-mail address: p.andres@uam.es (P. Andrés).

http://dx.doi.org/10.1016/j.brq.2017.02.001
2340-9436/

Harris and Raviv, 2008; Adams and Ferreira, 2007; Baranchuk and Dybvig, 2009), there is little empirical evidence of their importance to corporate boards (Masulis and Mobbs, 2011). We try to help fill this gap in the literature by studying the impact of both non-independent and independent outside directors on CEO pay.

We analyze the relation between board composition and CEO compensation using a data set that contains information on 2308 Western European firms covering 15 countries over the period 1999–2007. We analyze the impact of independent directors and non-independent outsiders separately. If independent directors can effectively restrain insider self-dealing, as Bhagat and Black (2002) suggest, we should observe that firms with more independent directors on their boards pay more moderate pay packages than insider-dominated boards. Yet independent directors might lack the mandate, the incentives and the ability to closely monitor management (Gutierrez and Sáez, 2012), in which case they can substitute direct monitoring with an adequate pay system that aligns the interests of shareholders and management (Holmstrom and Milgrom, 1994).

Non-independent outside directors, on the other hand, have the proper incentives to closely monitor the managers (Hartzell and Starks, 2003). They are usually appointed by large shareholders and are, on average, less busy than independent directors. The close monitoring by non-independent outsiders can prevent rent expropriation from managers and moderate the average CEO pay package (Hermalin and Weisbach, 2003; Bebchuk et al., 2002; Bebchuck and Fried, 2005; Almazan et al., 2005).

In our analysis of European companies, we find that CEOs working for firms with a larger proportion of non-independent outsiders (grey directors) on their boards receive, on average, lower direct and total compensation than CEOs working for firms with fewer non-independent outsiders on their boards. A one standard deviation change in the proportion of non-independent outsiders on the board is related to a 4.2 percent ($0.25 \times 0.171 \times 100$) reduction in direct compensation and a 21 percent ($0.25 \times 0.86 \times 100$) reduction in CEO total compensation.

By contrast, we find that the proportion of independent directors is positively related to CEO compensation, specially to the grant of equity-linked compensation. An increase of one standard deviation in the proportion of independent directors is associated with a 0.6 percent ($0.22 \times 0.274 \times 100$) increase in direct compensation and a 51 percent increase ($0.22 \times 2.32 \times 100$) in equity-linked compensation. While the presence of independent directors does not have a significant relation to the amount of cash compensation paid to the CEO, it has a strong positive relation to the presence of stock and stock option grants in the compensation packages. As a result, the equity mix (the proportion of equity to total compensation) is significantly larger for companies with more-independent boards.

Our results provide support for the hypothesis that non-independent outsiders serve as effective monitors to moderate pay packages, while independent directors, lacking the means or incentives to monitor, rely on costly incentive packages to align interests (such as stock and stock options) that might prevent pay moderation.

This different effect of non-independent and independent directors on CEO pay reflects the role of non-independent outsiders (mainly block-holders) when deciding the managerial compensation package. This question is very relevant in the current political debate, as the efforts to harmonize corporate governance standards in Europe put special emphasis on increasing board independence.[1] In fact, regulators from most countries include in their Codes of Corporate Governance recommendations to set up boards with a vast majority of independent directors and remuneration committees consisting of independent directors. However, this prevalence of independent directors might come at the expense of limiting the role of major shareholders, represented by non-independent outsiders, whose influence in the governance of the firm might be curtailed.

Our analysis aims to contribute to the literature in several ways. First it expands our understanding of how different governance mechanisms (board composition and CEO incentive pay) interact in listed companies. We take advantage of the international nature of our panel to highlight the different role played by outside directors (independent and non-independent) adding evidence for Europe of a phenomenon that has been studied mainly using US data (Guthrie et al., 2012; Chhaochharia and Grinstein, 2009; Fahlenbach, 2009; Chung, 2008 or Hartzell and Starks, 2003; Holmstrom and Kaplan, 2003; Core et al., 1999). For example, Core et al. (1999) find that CEO compensation is higher in the US when a greater percentage of the board is composed of outside directors that are appointed by the CEO or are considered ''grey'' directors. In Europe, large shareholders usually influence the nomination of non-independent outsiders to board positions. This cross-national diversity of corporate governance yields different board-CEO relations (Aguilera and Jackson, 2003) that might be reflected in the level and structure of compensation packages. When we control for different ownership structures, dimensions of board of directors, company characteristics and performance and institutional backgrounds, the results indicate that the presence of non-independent outsiders moderates CEO compensation and makes it less linked to performance. By contrast, boards with more independent directors rely more on equity-linked compensation which is a costly instrument (Bebchuck and Fried, 2003) that might provide inadequate incentives (Fahlenbrach and Stulz, 2011) and induce excessive risk taking (Coles et al., 2008b).

Second, this paper adds to the published empirical literature about board composition (Boone et al., 2007; Coles et al., 2008a; Linck et al., 2008, 2009; Guest, 2008; Wagner, 2011; Core et al., 1999) and, more specifically, to those papers that link board composition with different aspects of the performance of governance instruments. Using different aspects of performance, these studies avoid the murky relation between board composition and value, where concerns about endogeneity are well known (Hermalin and Weisbach, 2003). Our link between non-independent outsiders and CEO compensation adds to other specific relations studied recently for European companies, such as board composition

[1] See, for example, recommendation 2005/162/EC on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board.