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Remuneration of non-executive directors: Evidence from the UK

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ABSTRACT

This study examines the remuneration of non-executive directors, examining individual monitoring characteristics and director capital in addition to firm characteristics. Using a large sample of FTSE All-Share non-executive directors from 2001 to 2012, we find that remuneration is positively linked to both directors' individual characteristics and firm characteristics. We find that director age, tenure, and network size are positively related to remuneration, suggesting that directors' ability to contribute to board decision-making and their set of resources are valued by firms. We find that director remuneration is negatively related to monitoring characteristics such as director independence, suggesting possible agency considerations, as effective monitors of top management are paid less. However, director ownership has a non-linear relationship with remuneration, and is substitutive at higher levels of ownership. We also observe that UK boards are relatively homogeneous, with few female directors and even fewer Chairmen, and find strong evidence of a gender gap in remuneration when examining inter- and intra-firm variations. Our findings have implications for regulators who seek to intervene in board appointments, as they indicate that firms do not necessarily value or reward resources brought by female or independent directors.

1. Introduction

Non-executive directors serve a number of important functions on the board of directors, such as monitoring senior managers and contributing to strategic decision-making.[1] They also contribute a valuable set of resources and bring experience to the firm. While there is extensive research on how senior executives, such as the CEO, are rewarded, little is known about the remuneration of non-executive directors. In this study, we investigate the remuneration of non-executive directors, and present an overview of their individual characteristics, using a large sample from the United Kingdom. Building on earlier research which examines firm characteristics, we examine how firm and director-specific characteristics are related to non-executive director remuneration. Our setting is distinct from prior studies on non-executive director remuneration based on data from the United States, since the remuneration of non-executive directors in the UK is almost entirely cash-based, with

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[1] Non-executive directors in the UK are members of a unitary board of directors that is composed of both executive and non-executive directors. Non-executive directors are commonly referred to in the United States as 'outside' directors and in some jurisdictions as 'supervisory' directors. For consistency, in this paper we use the term 'non-executive', the terminology of firms and regulators in the UK.

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no performance-related element, suggesting that their remuneration is largely set ex-ante. While corporate governance guidelines in the UK give extensive guidance on executive pay, they suggest only that firms compensate non-executive directors for their ‘time commitment and responsibilities of the role’ (Combined Code, 2003, §B.1.3).

In the past two decades, non-executive directors have received significant attention from regulators and academics as a mechanism for strengthening firm governance, with corporate governance guidelines focussing on their roles on boards of directors (Cadbury, 1992; Greenbury, 1995; Hampel, 1998; Higgs, 2003; Tyson, 2003; UK Corporate Governance Code, 2010). Spillover effects from the UK also influence developments in the European Union, such as the Green Paper on Corporate Governance (EC, 2011). Table 1 shows that the average proportion of FTSE All-Share boards comprised of non-executive directors increased from 54% in 2001 to 66% in 2012, highlighting that their overall importance in decision-making and in monitoring the top management team has intensified during this period.

Despite the importance of the role of non-executive directors in corporate governance, little is known about the nature of the collective body of non-executive directors in recent years and how they are remunerated. Studies have typically considered the number of non-executive directors as a part of the board's monitoring function, non-executive director ownership, CEO/Chairman duality, and compliance with corporate governance codes (Dahya & McConnell, 2005; Dedman, 2000; Mura, 2007; Young, 2000). However, these studies consider aggregated board data and are largely based on the Cadbury (1992) regime, which has been superseded by more recent corporate governance guidelines including the Combined Code (2000 and subsequent revisions), and the Higgs (2003), Tyson (2003), Walker (2009), and Davies (2011) Reports, which recommend new best practices, including financial expertise on the board, tests of non-executive director independence, and greater representation of women on the board. Our study therefore provides new insight into the characteristics of non-executive directors in more recent governance regimes.

The role of non-executive directors can be generally classified into control (monitoring), contributing to strategic decision-making (service), and enhancing the board's set of resources (resource dependence) (Johnson, Daily, & Ellstrand, 1996). First, research on non-executive directors using an agency framework considers their role as monitors in mitigating the agency problem. Strong monitoring should ensure that the firm is more efficient in its contracting with senior managers, reducing agency costs. Second, non-executive directors, through their experience and expertise, are expected to provide services to the board in the form of advice, counsel, and expertise on issues of strategy, resource allocation, risk management, succession planning, remuneration, and standards of conduct (Higgs, 2003). Third, resource dependence theory suggests that the board is a provider of resources and opportunities to the firm, through directors' information sets, links to other organizations, and network of ties to other firms (Hillman & Dalziel, 2003). Therefore, the contribution made by individual directors, based on their capabilities and experiences, are important to board effectiveness.

We use these three dimensions (monitoring, service, and resource dependence) to comprehensively examine non-executive director remuneration. In doing so, we contribute to the relatively limited body of research on remuneration of non-executive directors, which has thus far largely focused on firm-specific determinants, using data from the US. Because of growing pressures for gender diversity we also examine the remuneration of female directors.

Prior research and UK governance regulations on remuneration have focused primarily on executives, in particular the CEO (ABI, 2011; Combined Code, 2006; DRRR, 2002), and ‘compensation of non-executive directors is also only briefly and indirectly addressed in previous studies’ (Hahn & Lasfer, 2011, p. 591). The relative paucity of research on non-executive

Table 1
Average non-executive director remuneration and board composition in listed UK companies, 2001–2012.

Year	All non-executive directors		Chairmen		Other non-executive directors		Director characteristics	
	Mean £'000	Median £'000	Mean £'000	Median £'000	Mean £'000	Median £'000	Board%NED	Board%Female
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
2001	57.1	30.0	159.1	95.0	34.4	28.0	53.7	5.0
2002	59.0	32.0	163.4	98.0	35.2	30.0	53.2	5.4
2003	64.6	35.0	172.1	95.5	37.6	30.0	55.0	6.1
2004	66.7	38.5	165.1	100.0	40.8	34.0	56.9	6.7
2005	71.5	43.0	170.9	106.0	46.6	38.0	59.2	7.7
2006	82.1	45.0	208.1	116.5	49.1	40.0	60.0	7.1
2007	84.9	50.0	211.8	125.0	52.4	43.0	61.2	7.1
2008	91.5	53.0	223.4	150.0	58.2	46.0	62.3	8.8
2009	94.5	55.0	235.8	155.0	61.1	50.0	63.6	9.9
2010	98.6	57.0	249.3	158.0	63.0	51.0	64.2	10.1
2011	106.5	63.0	256.7	166.0	70.1	55.0	65.1	10.5
2012	110.3	66.0	267.1	171.5	70.0	57.0	66.1	11.1
% Change	93.2%	120.0%	67.9%	80.5%	103.7%	103.6%		
Mean							60.0	8.0

This table reports the mean and median remuneration for all non-executive directors, Chairmen, and other non-executive directors by year during the 2001–2012 period in £'000, (Columns 1–6). Column 7 reports the average percentage of the board composed of non-executive directors, and Column 8, the average percentage of sample non-executive directors that are female.