International Business Review 24 (2015) 175–186

Contents lists available at ScienceDirect

International Business Review

journal homepage: www.elsevier.com/locate/ibusrev

The remuneration of independent directors in the UK and Italy: An empirical analysis based on agency theory

Chris Mallin [a], Andrea Melis [b,*], Silvia Gaia [b]

[a] University of East Anglia, United Kingdom
[b] University of Cagliari, Italy

ARTICLE INFO

Article history:
Received 5 November 2013
Received in revised form 24 June 2014
Accepted 2 July 2014
Available online 22 July 2014

Keywords:
Agency theory
Corporate governance
Independent non-executive director
Italy
Remuneration
UK

ABSTRACT

This study investigates independent non-executive directors' remuneration from an agency theory perspective, taking into account both optimal contracting and managerial power perspectives. Using a sample of 1733 independent non-executive directors' year observations in Italian and UK non-financial firms listed in the period 2007–2009, we find that in both countries independent non-executive directors' remuneration is mainly based on the observable effort they exert and their responsibilities. Our findings also show that independent non-executive directors who do not fulfil formal independence criteria, as stated in the respective national corporate governance codes, seem to be paid more than those who do fulfil such criteria, particularly in the UK.

Our findings contribute to the existing literature by providing evidence on the determinants of independent non-executive directors' remuneration in two major European economies and offer insights to policy-makers by questioning the effectiveness of adopting non-binding criteria when assessing non-executive directors' independence.

1. Introduction

Independent non-executive directors (hereafter INEDs) are expected to act as monitors of, and advisors to, executive directors on behalf of shareholders (Fama & Jensen, 1983). INEDs represent a key corporate governance mechanism and their presence on the board of directors and on the board committees is a commonly recommended governance practice (Zattoni & Cuomo, 2010). Although it has been argued that candidates may be attracted to INED positions for other than pecuniary reasons (Fama & Jensen, 1983; Mace, 1971, p. 109; Lorsch & MacIver, 1989, p. 30), empirical evidence has shown that remuneration is an essential factor for INEDs (Adams & Ferreira, 2008; Certo, Dalton, Dalton, & Lester, 2008).

On the one hand, INEDs' remuneration signals the quality and effectiveness of INEDs in performing their roles. INEDs are facing increasing duties and legal responsibilities, the demand for effective supervision by INEDs being reflected in the latest regulatory initiatives in various countries (Lazar, Metzner, Rapp, & Wolff, 2014). This increase in INEDs' duties and legal responsibilities leads not only to a greater time commitment but also exposes INEDs to a greater reputational risk. High levels of INEDs' remuneration could reflect the time commitment (Adams & Ferreira, 2008) and reputational risk that accompanies the INEDs role (e.g., Aguir, Burns, Mansi, & Wald, 2014; Linck, Netter, & Yang, 2009). On the other hand, INEDs' remuneration might also reveal INEDs' ineffectiveness because of the potential reciprocity between INEDs and corporate insiders where ineffective monitoring makes corporate insiders more inclined towards INEDs' remuneration increases (Bebchuk, Fried, & Walker, 2002). From this perspective, INEDs' remuneration could represent a "reward" for ineffective monitoring actions resulting from the collusion between INEDs and corporate insiders. Therefore understanding more about INEDs' remuneration is particularly important. However, despite its theoretical and practical relevance, the remuneration of INEDs has received little attention so far and has been referred as an "enigma" (Hahn & Lasfer, 2011; Magnan, St-Onge, & Gélinas, 2010), regarding both the amount and the design (Brown, 2007; Magnan et al., 2010; Shen, 2005). In this paper we help to fill this lacuna in the literature.

Most of the literature on corporate governance, including the studies on the design and level of directors' remuneration, mainly

* Corresponding author. Tel.: +39 0706753302.
E-mail address: melisa@unica.it (A. Melis).

http://dx.doi.org/10.1016/j.ibusrev.2014.07.006
0969-5931/

relies on agency theory (e.g., Cordeiro, Veliyath, & Eramus, 2000; Fernandes, Ferreira, Matos, & Murphy, 2013; Jensen & Murphy, 1990; Tosi & Gomez-Mejia, 1989). This study aims at investigating to what extent agency theory can explain INEDs' remuneration in different contexts, taking into account both an optimal contracting view and a managerial power perspective. In particular it considers the potential determinants of INEDs' remuneration as being the INEDs' effort and responsibilities that are observable by shareholders and also the INEDs' potential conflicts of interest where the formal independence criteria, as embodied in the corporate governance codes, have not been adhered to.

The paper makes a number of key contributions to the existing body of knowledge. First, it provides new insights on the determinants of INEDs' remuneration, in particular the criteria by which INEDs are remunerated, which is an important issue given the potential for agency problems between boards of directors and shareholders (Andreas, Rapp, & Wolff, 2012; Bebchuk et al., 2002; Certo et al., 2008). In particular, by analysing the influence played by INEDs' observable effort/responsibilities and/or the conflicts of interest in their remuneration in Europe, we extend the scant literature which is mainly focused on the debate in North America on whether the pay-for-performance principles for rewarding executive directors are applicable to INEDs (e.g., Cordeiro et al., 2000; Hempel & Fay, 1994; Magnan et al., 2010; Ronen, Tzur, & Yaari, 2006; Yermack, 2004). Given the characteristics of the INEDs' job as well as the recommendations by most corporate governance codes in Europe (e.g., Dutch Corporate Governance Code, 2008; ICGN, 2010; Italian Code of Conduct, 2006, 2011; Spanish Unified Good Governance Code, 2006; UK Corporate Governance Code, 2012) investigating whether INEDs' remuneration reflects their effort and responsibilities and/or rather a conflict of interest becomes relevant as it provides an understanding as to what extent INEDs' remuneration reflects an optimal contracting perspective or a managerial power perspective of agency theory. In line with the Van Essen, Otten, and Carberry (2014) study on executive remuneration, we find that optimal contracting and managerial power perspectives seem to provide complementary, rather than competing, explanations to INED's remuneration, as they encompass different contracting arrangements covered by agency theory.

Second, by conducting a study on two institutional settings, Italy and the UK, that can be characterized as opposite ends of a spectrum in terms of their corporate governance mechanisms, we investigate whether agency theory can be applied to very different contexts (e.g., Bowe, Filatotchev, & Marshall, 2010; Cho, Huang, & Padmanabhan, 2014). Critics of agency theory have pointed out its under-contextualized nature, and hence its inability to accurately compare and explain the diversity of corporate governance practices across different institutional contexts (e.g., Aguilera & Jackson, 2003; Van Essen, Heugens, Otten, & Van Oosterhout, 2012). In this vein, Aguilera, Filatotchev, Gospel, and Jackson (2008) argue that a 'closed-system approach' within agency theory posits a universal set of relationships between corporate governance practices and devotes little attention to the distinct contexts in which firms are embedded. However, supporters of agency theory argue that agency theory does not necessarily rule out institutional factors (e.g., Eisenhardt, 1988; Bender, 2004; Wiseman, Cuevas-Rodríguez, & Gomez-Mejia, 2012). Despite the fact that agency problems (such as information asymmetry, conflicts of interest, and opportunistic agent's behaviour) are universal, as long as delegation is involved, their explicit manifestation and the ways to deal with them may vary depending on institutional context (Wiseman et al., 2012). Agency contracts are socially embedded such that differences in the institutional contexts surrounding the principal-agent relation can affect the form of governance that is used (Wiseman et al., 2012).

Third, the choice of these institutional settings answers the call of Aguilera and Cuervo-Cazurra (2009) for a more careful examination of what each Code of Corporate Governance contains to understand the soundness of its recommendations as they are not homogeneous in content. In contrast with most of the corporate governance codes in Europe (e.g., Austrian Code of Corporate Governance, 2009; German Corporate Governance Code, 2009; Spanish Unified Good Governance Code, 2006) that have adopted a rules-based approach by requiring companies to consider a non-executive director to be independent only when several criteria are met, Italy and the UK are both countries whose corporate governance codes allow companies to deem a director as independent notwithstanding that all the independence criteria stated by the Codes are not fulfilled (Italian Code of Conduct, 2006, 2011; UK Corporate Governance Code, 2012). In such cases companies should explain this decision in the corporate governance report. This unique approach allows us to analyze the potential differences, in terms of overall remuneration as well as the relation with INEDs' effort and responsibilities, amongst the INEDs who fulfil all the independence criteria and those who do not.

The paper is structured as follows. The next section provides some background on the institutional settings for INEDs' remuneration in Italy and the UK. This is followed by the literature review and hypotheses' development. We then describe the research methodology, followed by the findings. Discussion of the results, concluding remarks and the limitations of the study are presented in the final section.

2. Institutional settings

The settings of Italy and the UK were chosen on the basis that important differences exist between the two corporate governance systems (Melis, 2000). Comparing institutional settings characterized by such diversity in corporate governance practices should enhance the potential generalizability of the findings, by allowing account to be taken of the potential variation existing in governance practices in firms that operate in highly developed countries (e.g., Minichilli, Zattoni, Nielsen, & Huse 2012). Italy is representative of the Latin civil law based 'insider-oriented' corporate governance system, while the UK is an example of the Anglo-American market-based outsider-oriented common law system (Weimer & Pape, 1999). Although Italian and UK firms operate in some of the largest and most developed economies, UK firms are often considered as having the best corporate governance practices in Europe (Heidrick & Struggles, 2009; RiskMetrics, 2009), while Italian firms have often been taken as an example of bad corporate governance practices (Johnson, La Porta, Lopez-De-Silanes, & Shleifer, 2000, Volpin, 2002; La Porta, Lopez de Silanes, Shleifer, & Vishny, 1997).

Moreover, UK listed firms are usually characterized by a principal-agent problem (Mallin, 2010), while Italian listed firms are characterized by a principal-principal agency problem (Melis, 2000), and different agency problems might have a different influence on remuneration practices (Bebchuk et al., 2002; Filatotchev & Allcock, 2010) as well as on the role of INEDs (Johanson & Østergren, 2010).

2.1. Italy

Italian non-financial listed firms are characterized by the presence of a controlling shareholder who is able to monitor directors (Melis, 2000; Volpin, 2002). His/her presence reduces the agency problem between executive directors and shareholders, but gives rise to the principal-principal agency problem between the controlling shareholder and minority shareholders (Melis,