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Institutional directors and board compensation: Spanish evidence☆

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Abstract We address the influence of directors who represent institutional investors in three aspects of board compensation policies: level of compensation, composition, and performance sensitivity. We differentiate pressure-sensitive directors (i.e., with business links) and pressure-resistant directors (i.e., without business links). Our results show that pressure-resistant directors decrease total board compensation and its fixed proportion, whereas they increase the variable proportion of total remuneration and the pay-for-performance sensitivity. By contrast, pressure-sensitive directors offer the opposite results. These findings are consistent with the view that institutional investors are not a homogeneous group and that pressure-resistant directors fulfill a more thorough monitoring role.
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Introduction

Corporate compensation schemes have been a high priority issue in the agenda of corporate governance reforms. In an attempt to improve corporate governance in public firms and to mitigate potential conflicts of interest, the European Commission recently issued several recommendations (2009/384/EC; 2009/385/EC) to enhance appropriate compensation policies, more detailed disclosure requirements, and a higher level of control for independent directors and shareholders within the pay setting process.

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In this debate regarding appropriate compensation policies, 90% of institutional investors believe that corporate executives are overpaid (Brandes et al., 2008). This perception has led some institutional investors to give up their traditional passive role and become actively engaged in the compensation decisions at their portfolio firms (Bushman and Smith, 2001; Hartzell and Starks, 2003). As institutional investors have emerged as a significant group of shareholders with the incentives and the capabilities to check managerial power, these investors also exercise their influence on the compensation schemes of their invested firms (Parrino et al., 2003).

The literature has found that institutional investors influence both the level and the structure of CEO pay in accordance with shareholder interests, which may be in conflict with the interests of CEOs (David et al., 1998; Hartzell and Starks, 2003). But, although prior research provides significant insights on the relationship between institutional investors' ownership and compensation, it has not yet addressed the effect of these shareholders as directors and the impact of their different nature on compensation policies.

With the notable exceptions of Hempel and Fay (1994), Boyd (1996) and Cordeiro et al. (2000), most previous literature focuses on CEO and executive compensation, so little is known about the determinants of the pay of other senior personnel. However, rapid growth in director compensation has caused a big controversy, since directors serving on the compensation committee can determine the level and mix of their own compensation packages (Cordeiro et al., 2000). This fact has led to potential conflicts of interests, different to the conflicts with managers, who do not set their own salaries. Indeed, according to Dalton and Daily (2001) the stock based compensation for directors is even more contentious than similar practices for officers.

The presence of directors appointed by institutional investors on the board is rising across countries and, accordingly, these institutions are becoming more influential in the corporate governance. Heidrick and Struggles (2011) find that, although directors appointed by institutional investors only account for 2% of British firms directorships, they account for 40% of directorship in Spain, 35% in Belgium, and 22% in France. Moreover, due to an alleged lack of efficiency of independent directors in European countries, some authors highlight that the supervising role in these environments is actually played by directors appointed by institutional investors (Sánchez Ballesta and García Meca, 2007). Given the widespread importance of institutional investors, a better understanding how their presence on boards affects their own compensation schemes is clearly needed, especially in civil-law countries where these directors are taking up an increasingly active role in their firms' corporate governance.

We study the impact of institutional directors on two aspects of remuneration policy: composition and sensitivity. We also check whether institutional directors have a significant moderating effect on the relation between performance and board remuneration. The literature shows that institutional investors do not act as a monolithic group in firm governance (Almazán et al., 2005; Cornett et al., 2007; Chen et al., 2007; Choi et al., 2012). Accordingly, we propose that the type of business relation between firms and institutional investors is the key to describing the role of institutional directors. We therefore study the relation between remunerations and institutional directors, making a distinction between the institutional investors who keep business relations with the firm on whose board they sit and the institutional investors whose business activity is not related to the company in which they hold a directorship.

We use a sample of Spanish listed firms between 2004 and 2010. Spain is likely the best paradigm to study the effectiveness of institutional directors for two main reasons. First, Spain is the European country with the highest presence of institutional investors on the boards of large firms (Bona et al., 2011; Crespí and Pascual, 2012). Second, the Spanish financial system is bank oriented. Banks play an outstanding role both as creditors and blockholders. Banks also appoint a significant proportion of directors to the boards of their client firms.

Our results suggest that maintaining business ties between firms and institutional investors affects the role of the institutional investors. Directors appointed by pressure-resistant investors serve a monitoring role that mitigates the agency problem between shareholders and manager. Coherent with their disciplinary role, pressure-resistant directors increase the relative weight of the variable compensation, decrease the proportion of fixed compensation, and induce compensation packages sensitive to performance. These findings are consistent with the view that differences exist between these two types of directors and that pressure-resistant directors fulfill a more thorough monitoring role.

We make several contributions to the literature. First, we provide new evidence on the effects of directors appointed by institutional investors on remuneration policy in a way that is difficult to capture in the US or UK context, where this kind of director is less prevalent. Existing studies on the effects of institutional investors are commonly based in the framework of the conventional US/UK model of corporate control and therefore, in general, focus on institutional investors solely as shareholders. Second, we provide new evidence on the effect of board composition on director remuneration. Although managerial compensation has been often analyzed, directors' pay has only recently sparked an intense debate in Europe. The wave of corporate scandals has renewed concerns about the effectiveness of board monitoring and the high compensations that directors' receive. Finally, our examination of whether institutional investors' presence on boards of different types of institutions, such as banks or investment funds, leads to observable differences in remuneration policy can provide new insights on the heterogeneity in monitoring costs across institutional investors, which, in turn, has important implications for the debate over the proper degree of institutional involvement in corporate governance.

Theoretical foundations and hypotheses development

Theoretical background

Although small shareholders can vote with their feet if they do not agree with the performance or actions of managers, institutional investors find it difficult to offload

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