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What Do Compensation Committees on the Boards of Public Companies Do? Comparisons of Indian and U.S. Process Differences Juxtaposing Complementary Theoretical Lenses

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This study examined the processes undertaken by compensation committees (CCs) on Indian public company boards building on the CC process study of U.S. public company boards reported in Hermanson et al. (2012). The Indian data reported here were gathered through scripted, in-depth, semi-structured interviews of 21 Indian directors (17 CC members, two Management Committee members and two directors, all of whom dealt with compensation matters on their boards).

In keeping with agency theory predicates, Indian CC processes were designed to safeguard the independence, knowledge and expertise of CC members, while ensuring they had access to the resources needed to make sound and informed decisions. Compensation principles emphasized paying for performance, ensuring a proper mix of compensation, benchmarking to market practices and retaining good talent. There were some process differences among Indian organizational archetypes like family businesses, public sector firms, multinational subsidiaries (MNCs) and promoter-controlled firms, suggestive of neo-institutional theory influences.

Notable differences from U.S. CC practices were that Indian CC practices were less formal, and directors were seen to be more partners of management playing broader roles extending beyond traditional agency-theory-driven fiduciary responsibilities. Some of these differences could portend the existence of secondary (principal-principal) agency problems. There were other process differences from U.S. practices, arising from institutional and cultural variations. In particular, institutional frameworks and statutory limits appeared to circumscribe the Indian CCs' role, enabling greater managerial oversight of CC processes and engendering a more collectivist ethos among CCs in India. CC practices in the Indian context also lead us to discern some elements of an underlying tension between agency theory and institutional theory. These underlying tensions are further compounded by firm ownership differences (family, business group, MNC subsidiary, government owners, majority control, etc.). This is where we argue that neo-institutional influences based on ownership structure differences manifest themselves. To the best of our knowledge, our study represents a pioneering attempt at depicting these latent tensions between agency and institutional theory, and in teasing out how neo-institutional influences impact CC practices, thereby furthering our understanding of these phenomena. Cumulatively, these findings provide important directions for advancing theory, and enabling a more grounded and holistic understanding of CC processes.

Since CCs were not mandatory for Indian public companies at the time this study was conducted, requiring CCs on all Indian company boards (as the revised 2013 Indian Companies Act has mandated) would provide an added fillip to legitimizing and formalizing the role of this committee. However, because of the existing differences in the institutional and socio-cultural contexts, it is unlikely that CC processes across the Indian and U.S. company boards will converge and become completely uniform or homogeneous.

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Introduction

> "The basic role of the compensation committee is twofold. First is to be the 'owner' of the company's executive and director compensation philosophy and programs. Second is to provide the primary forum in which core compensation issues are fully and vigorously reviewed, analyzed, and acted upon (either by the committee itself or by way of recommendation to the full board or to independent directors as a group)."
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> -Reda et al., 2007, 12.

Compensation Committees (CCs) are primarily responsible for evaluating and compensating the CEO, directors and upper echelons of management. They help to recruit, retain and motivate the CEO, as well as other top management talent, critical to achieving the company's mission. The processes CCs undertake, and the resulting decisions, affect the well-being of the company, as well as the perceptions and the buy-in of a broad array of organizational stakeholders. These processes

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and resulting decisions lie at the core of corporate governance. Effective corporate governance processes require engendering the participation of, facilitating interactions between, and maintaining a balance among, the interests of the top management team, the board and different organizational stakeholder groups.

Since the Indian economy opened up in 1991, many changes have taken place to bring Indian corporate governance practices more in line with those in Western countries. International institutional investors[1] have entered India seeking both to benefit from the superior returns provided by Indian companies, as well as to diversify the risk in their portfolios. These institutional investors also bring to India their sophisticated awareness, monitoring, best practices and activism. Concurrently, Indian companies themselves have stepped up the pace of their internationalization, and many have undertaken cross-listings in overseas bourses located in advanced economies. They have done so in order to raise capital, seek new markets for their products and services, and acquire new technologies. These moves have necessitated an enhancement of credibility and name recognition, particularly with Western customers and investors. These moves have also forced these companies to upgrade their governance practices to bring them in line with practices in more economically advanced countries. Finally, in recent times there have been a few widely publicized corporate governance scandals among prominent public companies in India (see Narayanaswamy et al., 2012). These were wake-up calls, and have heightened recognition of the need for tighter corporate governance standards and frameworks more consistent with those practiced in Western countries.

It was primarily in light of all the above developments that we undertook this study of CC practices in Indian public companies. Our research attempts to make a threefold contribution. First, our study illustrates the phenomenon of how standard agency predicates (which are usually context-agnostic) appeared to pull firms in India toward U.S./Western governance principles and associated CC practices. This creates an underlying tension between agency and institutional predicates (which are context-dependent). These underlying tensions are further compounded by intra-firm ownership differences (family, business group, MNC subsidiary, government ownership, majority control, etc.). Such differences by controlling ownership types also exacerbate secondary agency problems, where dominant or powerful shareholder groups appropriate returns at the expense of minority shareholders. This is also where we argue that neo-institutional influences manifest themselves based on ownership structure differences. To the best of our knowledge, our study represents a pioneering attempt at depicting these latent tensions between agency and institutional theory in the Indian context and, further, depicting how neo-institutional influences impinge on CC practices, thereby advancing our understanding of these phenomena.

Secondly, there is a dearth of process studies on boards and especially on CCs. We contribute to this sparse literature on process studies and seek to inform both academics and practitioners. While this study builds on a similar CC process study conducted earlier in the U.S. (Hermanson et al., 2012), there is a paucity of research on board processes, particularly outside the North American or UK context. Our study focusing on CC practices in a large and important emerging economy is an attempt to bridge this significant gap. Through our interviews of 21 Indian directors (seventeen CC members, two Management Committee members and two board members, all of whom dealt with compensation matters on their boards), we aimed to provide insights into processes currently in vogue in CCs[2] on the boards of Indian public companies, thereby enhancing awareness among academics and practitioners alike of the happenings inside this “black box”.

Thirdly, we have a unique context to examine the issues we focus on. This is the first Indian study on CCs, and possibly in emerging economies as a whole. Given the importance of emerging economies, it is important to gather and provide evidence from this part of the globe in order to understand the extent to which existing theoretical lenses can adequately explain the phenomena observed in these contexts. India’s institutional setting is substantially different from that of the U.S. Using Hermanson et al. (2012) as a comparative foil, this study identifies and provides theoretical explanations for some of the observed process differences between India and the U.S. Also, India is an ideal setting for this purpose, given the country’s size and future potential, and because of the corporate governance changes being undertaken even as this study was being conducted.

The next section covers the literature review, followed by discussions of the theoretical background and institutional differences between the U.S. and India. Then, key findings from Hermanson et al. (2012) are outlined. We then describe the methods and the samples, discuss findings from the Indian study, and draw broad comparisons of U.S. and Indian study processes. The final section of the paper presents the conclusions.

[1] Mohan and Ramarathinam (2012) document the growth of quantum of FII (Foreign Institutional Investors) portfolio investments into India. India’s net yearly FII inflows from the U.S. grew from $0.83 billion in 1993 to $29.32 billion in 2010.

[2] CCs were not statutorily mandated on all Indian public company boards at the time of this study during 2009 and 2010 when the Companies Act of 1956 was the prevailing statute. Section 178 of the new Companies Act of 2013 now mandates the establishment on boards of a Nominations and Remunerations Committee consisting of three or more non-executive directors out of which not less than one half will be independent. Section 178 (2) on Page 105 mandates that “the Nomination and Remuneration Committee shall identify persons who are qualified to become directors and who may be appointed in senior management in accordance with the criteria laid down, recommend to the Board their appointment and removal and shall carry out evaluation of every director’s performance.” Section 178 (3) on Page 105 requires that “the Nomination and Remuneration Committee shall formulate the criteria for determining qualifications, positive attributes and independence of a director and recommend to the Board a policy, relating to the remuneration for the directors, key managerial personnel and other employees.” Throughout this manuscript, the details pertaining to the new Companies Act, 2013 have been sourced from the document available from *India Code,* a website containing the various enactments pertaining to India, and is under the purview of the legislative department of the Ministry of Law and Justice, Government of India (See http://indiacode.nic.in/acts-in-pdf/182013.pdf. For the purposes of our study this website was last accessed on November 17, 2014).

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