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Independent directors, non-controlling directors, and executive pay-for-performance sensitivity: Evidence from Chinese non-state owned enterprises☆

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ABSTRACT

We investigate the monitoring effect of different types of board directors on executive pay-for-performance sensitivity in Chinese non-state owned enterprises (non-SOEs). We find that the board representation of non-controlling shareholders has a positive impact on executive pay-for-performance sensitivity, while independent directors have a negative impact on pay-for-performance sensitivity. We further find that the positive effect of non-controlling directors is mediated by the ownership level of non-controlling shareholders, and by the controlling shareholder-manager duality. Our empirical evidence suggests that non-controlling directors have a monitoring effect in Chinese non-SOEs, and independent directors do not. Finally, we document that when non-controlling shareholders have relatively high ownership, non-controlling directors are better able to monitor firms' operations, which in turn leads to better firm performance.

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1. Introduction

Corporate board structure and its effect on corporate governance have long been discussed and disputed. In particular, independent directors have been recognized as the most widely adopted governance tool to mitigate the conflicts of interest between shareholders and managers (Hermalin and Weisbach, 1998). However, whether independent directors play an effective role in corporate governance is far from conclusive even in the U.S. (Coles et al., 2014; Larcker and Tayan, 2015). Unlike the board structure in the U.S. and other developed countries, there are two types of outside board directors in a typical Chinese firm: independent directors and non-executive directors. Independent directors refer to the directors who hold no posts in the company other than the position of director, and who maintain no relations with the company they oversee, while non-executive directors are primarily those non-controlling directors who represent the interests of non-controlling shareholders (hence also called non-controlling directors). This paper investigates the distinct monitoring effects of different types of outside directors on executive pay-for-performance sensitivity.

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This research is motivated by two trends in the literature. First, classical agency theory argues that, due to reputational concerns, independent directors can be an effective governance mechanism in selecting, monitoring, and supervising the top management teams in firms. This can in turn reduce the conflicts of interest between corporate managers and shareholders, hence increasing firm performance (Fama and Jensen, 1983). Several empirical studies indeed find a positive association between independent directors and firm performance (Brickley et al., 1994; Peng et al., 2015). Second, a large amount of literature documents that independent directors are perfunctory, and finds no direct relationship between board independence and firm performance (Kesner et al., 1986; Klein, 1998). These conflicting findings are due partly to the fact that these studies focus on the monitoring effect of independent directors as a group on corporate performance.

We argue that the effectiveness of the monitoring effect of independent directors depends on two factors: the election process of the independent board and the corresponding institutional environment for the election process. Consistent with this argument, Coles et al. (2014) find that the fraction of independent directors who are appointed before the CEO assumes office has more explanatory power for monitoring effectiveness than the conventional measure of board independence. In China, the process of appointing independent directors is largely influenced by top corporate executives, and these independent directors are concerned about their tenure in the firm when fulfilling their monitoring and supervising functions (Ye et al., 2011). In addition, the controlling shareholders have the final say as to whether an independent director can stay or not. As a result, independent directors in Chinese firms are closely tied with either CEOs or the controlling shareholders. Hence, they are not purely independent in this regard, and consequently they might find it difficult to confront CEOs when making suggestions on CEO compensation and other matters.

On the other hand, there is a large portion of non-controlling directors who do not serve as top executive managers in Chinese listed enterprises. These directors are nominated initially by non-controlling shareholders who also have certain influence on corporate decisions. As a result, non-controlling directors are more independent compared with other outside directors (Zhu et al., 2015), and have larger incentives and are better able to monitor the CEO and controlling shareholders. We conjecture that non-controlling directors are more active in monitoring the management team, increasing pay-for-performance sensitivity, and mitigating the adverse effect of controlling shareholders and management on corporate governance.

We focus on Chinese non-state owned enterprises (non-SOEs) rather than state-owned enterprises (SOEs), based on the following considerations. First, compared with SOEs, non-SOEs are better able to establish a well-defined ownership structure that facilitates effective monitoring which in turn can provide proper incentives for non-controlling directors to pursue objectives that are in the interests of firms and their shareholders. In contrast, Chinese SOEs lack a clear ownership identification, and thus, there is no clear guidance as to who should be monitoring corporate executives. The lack of a clear and enforced ownership structure undermines the effectiveness of corporate governance (Zhang, 2014), particularly the monitoring effectiveness of non-controlling directors. In addition, the ineffectiveness of corporate governance and monitoring in SOEs suggests not only that the first type of agency problem between shareholders and managers in SOEs is more severe than in non-SOEs, but also that shareholders and boards of directors might have weak control of top management. As a result, the monitoring effect of non-controlling directors is largely curbed in SOEs (Liu et al., 2012a, 2012b; Lu and Hu, 2015).

Second, the executives of Chinese SOEs, including CEOs and CFOs, are appointed directly by government authorities, not by their boards of directors. This hampers non-controlling directors' ability to effectively monitor these executives. On one hand, it is difficult for non-controlling directors to effectively monitor the decision-making power of executives of Chinese SOEs given their dual identities as both entrepreneurs and government officials, as well as the SOEs' pyramidal control structure (Quan et al., 2013). On the other hand, since executive compensation in Chinese SOEs is strictly regulated by Chinese laws,[1] executives of Chinese SOEs are largely compensated by on-duty consumption, grey income, and political reward (Lin, 2014). This weakens the association between executive compensation and performance measures in Chinese SOEs, and also renders it hard to accurately measure the pay-for-performance sensitivity associated with non-controlling directors in these firms.

Third, in SOEs, in addition to controlling shareholders, some non-controlling shareholders may also be state owned. Many empirical studies trace back the original actual shareholders of SOEs, and find that both the controlling shareholders and non-controlling shareholders are owned by state or government agencies. In some cases, controlling shareholders and non-controlling shareholders even come from the same government department. For example, Cui and Xia (2006) investigate the ownership structure of Xingye Housing Company, and find that in addition to the controlling shareholders, all the non-controlling shareholders are state owned. The founder of the company and other shareholders form a loose long-term ownership confederation. The majority of these shareholders belong to the same government department or are under supervision of the same government department. Consequently, the controlling shareholders and non-controlling shareholders have the same interests, coordinated by the same government department.

Finally, our study requires the data on controlling shareholder-manager duality. Unfortunately, such information is not available in SOEs, as the natural person controlling shareholders cannot be easily traced in these firms. To conclude, we focus on non-SOEs, since they have a clearly defined ownership structure and the natural person controlling shareholders can be identified.

Using a sample of listed non-SOEs in China from 2008 to 2013, we find a robust positive association between the board representation of non-controlling shareholders and executive pay-for-performance sensitivity. This association is especially strong for both CEO and CFO pay-for-performance sensitivity when non-controlling shareholders have a relatively large stake in firms. We also find that non-controlling directors exhibit a positive monitoring effect on CEO pay-for-performance sensitivity only when

[1] The compensation arrangements are actually given when executives are appointed (Chen et al., 2005).

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