A blanket cap on board tenure would do more harm than good

Just limit the terms of committees, such as audit and compensation, where independence is fundamentally important.

Alex Tan Tai Loong

The Business Times, 8 December 2016

GOOD board governance is essential - it is a decisive check against self-interested actions taken by managers that do not benefit the company. Due to their presumed independence relative to insiders, independent directors are generally perceived to be more effective in monitoring and controlling management, thus helping improve firm performance.

The Singapore Directorship Report 2016 shows that more than 64 per cent of corporate boards have at least one independent director (ID) who has served longer than nine years. Indeed, the growing ranks of long-serving directors occupying spots that otherwise might go to younger and fresher talent has sparked some controversy.

Activist investors, pundits, and regulators question whether an ID can continue to perform their role well if they were to stay too long on a board. A close-knit board is good for board performance, and increases trust and openness between board members and executive managers. But the worry is that long-serving directors may get too cosy with other board members and senior management and this could eventually compromise their ability to exercise judgement independently, or at the very least, muddy their ability to detect wrongdoing.

Longer tenure makes it less likely that any single director would be willing to voice a critical opinion that might jeopardise the close-knit atmosphere of the boardroom. Incoming directors too may feel crowded out by the clout and influence that a long-serving director carries, affecting their ability to act independently or even speak truthfully. Without a climate where fresh ideas are encouraged and accepted, there is a strong likelihood of groupthink.

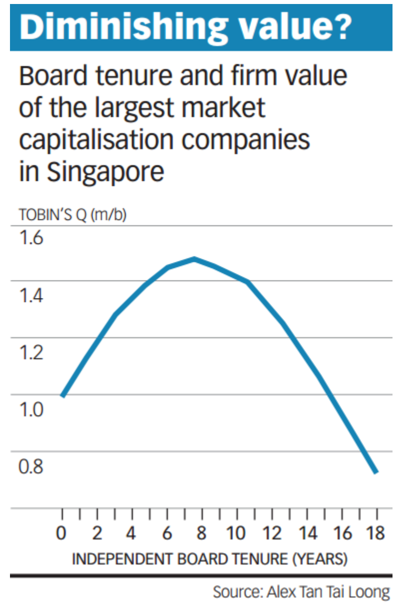
To establish the relationship between firm performance and the length of board tenure, I collected current data of all IDs from the largest companies by market capitalisation (S$1 billion and more) listed on the Singapore Exchange (SGX) in 2016.

Value-Add

In my analysis, I found that, on average, the value-add that independent boards - comprising only directors who were reported as "independent" in the company's annual reports - increased until about the ninth year and then subsequently decreased, as tenure increased. The graph plots Tobin's Q, a widely used indicator of firm value against independent director tenure using coefficient estimates from the regression.

We can make some working conclusions from this inverted U-shaped relationship. First, the entrenchment effect is real. Independence does slowly retreat. As a relatively new ID, whom I spoke to as part of my data collection, said: "Old timers are more likely to defend judgement calls and less willing to question . . . they went through ups and downs with the company."

Second, however, it does not discount the high worth of long-serving board members, who often provide useful background about a company - its industry, its history, and values. This is especially relevant in the context of the large proportion of family businesses listed on SGX. Seasoned directors can offer institutional memory and deep insight into company operations across a variety of economic and competitive environments. They also potentially have the experience and skill to question even long-time managers.



Third, at least for the majority of largest market capitalisation companies, they do self-correct and comply with the "nine-year rule". The median board tenure is 5.6 years and 8.7 years at the 75th percentile. However, this also means that 25 per cent of companies have independent boards with tenures that are longer than nine years. Can these independent directors truly be considered independent?

How then can we strike a balance between top-notch uncompromising governance and business friendly market rules?

Here is what I propose: Do not have a blanket cap on tenure but limit the terms of key committees of the board where independence is fundamentally important, such as the audit and compensation committees. The audit and compensation committees are at the heart of the board's monitoring role. Scrutinising and certifying financial documents are not only important for the company but also holds great importance for the general public and investors. Similarly, the uncompromised ability of directors to negotiate and set management's compensation at an optimal level is absolutely vital.

A full cap on tenure would carry too heavy a cost. Boards would have to lose qualified directors, even if they are still valuable members. And companies would forfeit the elusive insider attribute they were trying to mimic by extending tenure in the first place. It may also be difficult to attract "new blood" to the board to maintain engagement, relevance and rigour.

Motivation

If, however, tenure restriction was limited to the roles I mentioned, costs would be minimised, and at the same time, the motivation behind independence requirements would still be largely preserved. The costs associated with higher turnover on the audit and compensation committees are significantly smaller than for the board as a whole. Why? Uniformity in audit practice means that specific skills can be relatively easily picked up by incoming directors, thus ensuring that a company can quickly replace a departing director's audit knowledge. On the other hand, long-serving directors forced to leave their audit positions because of the cap on tenure may continue to serve in an advisory role where their experience is valuable.

Finally, for some directors, their directorship has become the last source of income and emotional link to their former identity as a professional or business leader. Companies should have the flexibility to celebrate the contributions of their stalwarts, and work with them to decide when it is time to give way to the younger generation. It is important however for companies to clarify whether long-serving outside directors are independent, or simply non-executive directors.

The writer is a senior research fellow at the Institute of Policy Studies, Lee Kuan Yew School of Public Policy, National University of Singapore.