

# The Diversity Gap in Corporate Boardrooms



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## Introduction

Boardrooms in Europe are becoming more diverse, but some countries are moving forward faster than others. When it comes to gender diversity, Norway, France and the UK are trailblazers, but other countries, for example Germany, Switzerland and Spain, are lagging much behind. Often, the debate is centered on female representation in the board of directors, but the concept of diversity has a far wider scope. For example, diversity of thought and skills, taking into account that individuals have differing cognitive styles and abilities. Furthermore, companies are now increasingly facing the challenge of achieving board racial diversity. A recent study by Harvard Law School found a persistent lack of racial diversity on U.S. corporate boards, with only 10% of boards being racially or ethnically diverse.

## A Brief Note on Diversity

Diversity is not an end, but a means to an end. The benefits of having a diverse board of directors are plenty:

- Diverse boards contribute to better problem solving and decision-making, foster greater innovation, and enhance board effectiveness and performance, because “group think” and expert overconfidence can be avoided.
- Companies often decide to create a board that reflects its diverse customer base, to better understand the environment that the business operates in.

- A diverse set of directors can provide additional skills and resources to the board. Having foreign directors on a company's board makes better cross-border acquisitions when the acquisition targets are from the foreign directors' home regions.
- There is also a positive effect on internal and external stakeholders. For example, IPOs experience significantly greater underpricing when the firm's board has at least one female director, driven by increased institutional investor demand for board gender diversity.
- Sometimes, the benefits seem small, but they can make a difference, for example, female directors have better board meeting attendance records than male directors, thereby improving board effectiveness and teamwork.

What are proven instruments to drive boardroom diversity? Looking both at Europe and the U.S., there are a variety of practices which can help to further improve the composition of companies' boards:

## Disclosures, Recommendations and Quotas

Stock exchanges and regulators have started to force companies to disclose data on boardroom diversity. For example, Nasdaq's Board Diversity Rule is requiring all its U.S. listed companies to publicly disclose diversity statistics regarding their board of directors, in a standardized format called the “Board Diversity Matrix”. In the U.K., the Financial

Conduct Authority (FCA) has launched new rules which force certain listed companies to disclose in their annual financial report whether they meet specific board diversity targets.

On international and national level, corporate governance codes are voluntary, non-binding measures meant to improve board practices, also in terms of diversity. The nature of their 'comply or explain' principle creates pressure from the public eye, and also helps to create awareness of the matter in the boardroom. This instrument is widely found in European countries, e.g. in Romania, Latvia, Finland and Sweden; its advantage is the fact that it is easier to modify than actual legislation.

A social-policy instrument of a quota defines a proportion or number of positions to be filled by, or allocated to members of a defined minority, are well established. Already in 2008, Norway became a pioneer by introducing a gender-quota law for boards. In 2016, Germany has implemented a quota which requires companies to appoint women for at least 30% of supervisory board positions. The "Women on Boards Directive" political agreement recently reached by the European Parliament requires at least 40% of the underrepresented gender to be represented in non-executive boards of listed companies. Most quotas have no expiry date, but some countries, such as Italy and the Netherlands, have introduced temporary quotas.

### Cultural Mind-Shift

If boards are simply fulfilling quotas without further consideration for the benefits that different perspectives and experiences can provide at the board level, they are missing out on a big opportunity. Even today, not all board directors understand the importance and benefits of board diversity. Incidents such as the #MeToo movement helped to create awareness about the importance of having an inclusive culture, both in the boardroom and in the wider organization, reflected by the presence of a critical mass of female directors in the board room. Companies with this kind of culture saw positive returns as #MeToo events unfolded. The role of the board's chair is to set the "tone from the top", to be the key driver in changing and improving culture.

### Target-setting, Reporting and Incentives

The board of directors, with a special responsibility falling on the Remuneration Committee, should set targets for management for developing and maintaining an "executive pipeline" of diverse individuals, and put executive rewards systems in place which drive for the desired outcomes. Currently, diversity & inclusion metrics are typically found in executives' short-term incentive plans. New indices such as the "2022 Corporate Racial Equity Tracker" offer a detailed accounting of the commitments and actions announced by the 100 largest U.S. employers.

### Strengthen and Upgrade the Selection Process

Diversity will not happen by accident. The Nomination Committee is often seen as the "step-child" of board committees, but can play an important role in creating greater transparency in board selection and appointment processes. Together with the board's Chair, it should take on the responsibility for driving change.

Even where female executives are appointed to boards, there is a notable delay in appointing them to chair one of the board's committees. As chairing a committee is both increasing visibility of female board director and preparing them for becoming Chair of a board itself, the appointment of female committee chairs plays an important role in improving board diversity.

Furthermore, the Nomination Committee can demonstrate a commitment to diversity itself, simply by its own diverse composition. In a recent study from Deloitte, looking at over 2000 companies and their boards in Europe, their research suggests that Nomination Committee themselves are lagging in female representation, with only 20% of all Nomination Committee chairs being female, compared to nearly 33% for the Audit Chairs.

### Widening the Talent Pool

In general, quotas can be effective. But, do not work as a standalone instrument, if the talent pool of qualified diverse director candidates is not large enough to avoid the negative consequences of such a quota, e.g. "overboarding" or appointing individuals not suitable for the role of a board director. Quota opponents often argue that quotas lead to appointing less talented boards directors. Therefore, widening the talent pool is important to have access to suitable candidates, who, in turn, will bring skills and characteristics which serve as competitive advantage to the firm.

Previous CEO or CFO experience is often a "fast track" into board roles. Research from European Women on Boards ("EWOB") shows that out of over 600 listed European companies, only 7% had a female CEO. While board appointments should always be made on merit, putting less emphasis on candidates' executive experience and looking at the individual as a whole, their potential, their cognitive skills can be an approach to find non-traditional profiles. This requires the board to be willing to appoint directors with no previous boardroom experience and invest resources in "onboarding" these directors into their new environment.

Unfortunately, often company polices of larger, listed companies which are, in theory, ideal "breeding grounds" for board directors, often reserve external board memberships to their own C-suite and senior executives, thereby limiting the

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development potential for their mid-level and divisional executive who could be “Next Generation” board members.

Executive Search Firms are instrumental in driving Board Diversity. Instead of primarily using the board of directors' existing networks to identify potential, candidates, search firms can help to cast a wide net in the search for diverse directors. They can help removing Unconscious Bias from the selection and evaluation process, and, due to their outside-in view of the board and the organization, are able to provide an independent view on the board's mechanisms and culture.

### Conclusion and Outlook

To improve boardroom diversity, all stakeholders must act with determination. While a lot of responsibility will be put on the board of directors and its committees, many more players in the field of corporate governance will need to become active. According to research by Yale School of Management, shareholders have not historically been proactive in using their votes to motivate companies to increase diversity among corporate boards, including shareholders who have been some of the most outspoken proponents of board diversity. Proxy advisory firms such as Glass Lewis and ISS play an important role by proposing to vote against nominating committee

chairpersons who fail to recruit and appoint diverse board directors.

Driving the improvement of diversity is not going to be successful if it is based on a “one size fits all” approach. It needs a specific strategy taking into account cultural and legal factors. A lot of “best practices” from all over the world have proven to be effective, while other showed less impact. To avoid that such diversity initiatives remain just a “window-dressing” exercise, learnings from these best practices need to be assessed and localized. Within the boardrooms, the Chairs and Nomination Committees, supported by specialized board consultants of executive search firms, will shoulder the responsibility to drive change towards sustainable and resilient diversity in the board of directors. ■

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