

The path to board diversity

Whitepaper produced by *Board Agenda* in association with Diligent



Overview

DIVERSITY IS WELL-ESTABLISHED on the boardroom agenda—but many boards are still far from diverse.

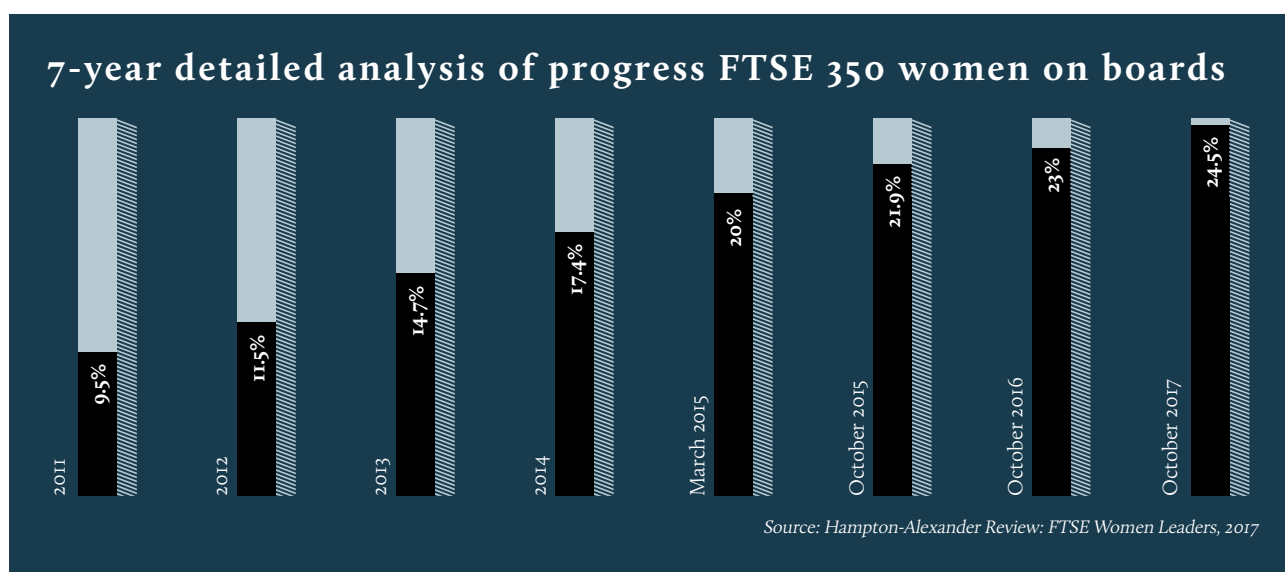
The number of women on FTSE 100 boards reached 30.2% in 2018, according to the third report of the Hampton-Alexander Review, the business-led initiative supported by the UK Government and successor of the Davies Review.¹ If progress continues at the same rate, the FTSE 100 will meet the 33% target for women on boards by 2020.

But the review also found five companies in the FTSE 350 with all-male boards, little change in the percentages of female CEOs or chairs, and 74 companies with only one woman on their board. In the FTSE 250, women account for just 24.9% of boardroom directors. These companies will need to ensure that 50% of all available appointments go to women to meet the 33% target by the end of 2020.

Diversity encompasses not only gender, but also ethnicity, age, disability, education, social background, nationality, career path and personality traits. Boardroom data on most of these is not available. However, Sir John Parker's review into the ethnic diversity of UK boards, *Beyond One by '21*, found that UK citizens of colour represent only about 2% of the total population of FTSE 100 directors.² Just over half (51%) of these companies had no directors of colour.

Also of concern is the limited diversity of people from other (non-UK) nationalities or cultures on top company boards. When independent think tank Global Future analysed this aspect of FTSE 100 boards in August 2018, it found that directors from emerging markets filled just 7% of positions—despite trade with these markets accounting for a quarter of British exports.³ It concluded that “although UK firms are more internationally diverse than their counterparts around the world, there are clear signs that they may be underprepared to gain penetration beyond traditional markets”.

Clearly there is more work to be done if boards are to become genuinely diverse.



¹ Hampton-Alexander Review, *FTSE Women Leaders. Improving gender balance in FTSE Leadership*. November 2017.

² Parker, Sir John. *The Parker Review Committee. A Report into the Ethnic Diversity of UK Boards. Final Report*, 12 October 2017.

³ Global Future. *The Global Future Diversity Index: International and Cultural Diversity in British Business*. October 2018.

Why board diversity matters

Interest in developing diverse boardrooms—and workforces in general—reflects a combination of both commercial and social factors. There is now a widespread expectation that all individuals should be able to succeed on merit in business—and that includes taking seats around the boardroom table.

Commercially, there is little disagreement that diverse boardrooms are associated with enhanced performance. McKinsey's 2018 report, *Delivering Through Diversity*, based on data from over 1,000 companies covering 12 countries, found that the statistically significant correlation previously identified between a more diverse leadership team and financial outperformance continues to hold true.⁴ Companies in the top quartile for gender diversity in their executive teams were 21% more likely to experience above-average profitability than companies in the fourth quartile. Companies in the top quartile for ethnic/cultural diversity on executive teams were 33% more likely to outperform on profitability.

And there is a penalty for low diversity. Companies in the bottom quartile for both gender and ethnic/cultural diversity were 29% less likely to achieve above-average profitability than all other companies. As McKinsey says, “not only were they not leading, they were lagging”.

Various research studies identify a range of benefits from diversity that help to improve business performance. More diverse companies are better able to:

- attract top talent;
- strengthen employee satisfaction and motivation;
- avoid “groupthink” and so improve decision-making;
- understand customer needs and preferences (including customers in different markets);
- reflect society and secure their licence to operate.

“The business case for fairness, equality and inclusion is clearer than ever, and financial institutions must embrace diversity in their organisation in order to reap the benefits.”

Mark Carney, governor, Bank of England, *Empowering Productivity: Harnessing the Talents of Women in Financial Services*⁵

“Business leaders are beginning to understand the importance of the diversity debate and increasingly frame it as a conversation about performance, productivity and the bottom line as well as a vital issue for our society to address.”

Melanie Richards, deputy chair KPMG, from the *2017 Hampton-Alexander Review on FTSE Women Leaders*⁶

⁴ Hunt, Vivian, Prince, Sara, Dixon-Fyle, Sundiatu and Yee, Lareina. *Delivering Through Diversity*. McKinsey & Company, January 2018.

⁵ HM Treasury and Virgin Money. *Empowering Productivity: Harnessing the Talents of Women in Financial Services*. 2016.

⁶ Hampton-Alexander Review, *FTSE Women Leaders. Improving gender balance in FTSE Leadership*. November 2017.

“Where we don’t see evidence of diversity among senior management, we ask questions and look for companies to demonstrate diversity in their succession pipeline and elsewhere in the business. We introduced a new voting policy... aimed at directors deemed responsible for market-lagging diversity practice.”

Michelle Scrimgeour CEO, EMEA at Columbia Threadneedle Investments⁹

Given the business benefits, investors now have diversity on their stewardship agenda. According to the Investment Association’s Stewardship Survey 2018 (based on survey responses from 59 firms, representing 71% of the £7.7 trillion managed in the UK by IA members), 56% of asset managers had engaged with companies on gender diversity, and 42% had made a voting decision informed by gender diversity.⁷ A 2016 survey by Hermes Investment Management showed that, for the first time, a majority of investors believe that gender diversity at the senior

management level is important or very important—51%, up from 25% the year before.⁸

BlackRock chairman and CEO Larry Fink, in his 2019 Letter to CEOs, stated that governance, including companies’ approach to board diversity, was an engagement priority for 2019.¹⁰

“Boards with a diverse mix of genders, ethnicities, career experiences, age, and ways of thinking have, as a result, a more diverse and aware mindset. They are less likely to succumb to groupthink or miss new threats to a company’s business model. And they are better able to identify opportunities that promote long-term growth.”

Larry Fink, BlackRock chairman and CEO, 2018 Letter to CEOs

Governments and regulators also expect companies to report on their diversity and policies to encourage more diverse leadership teams. For example, the revised 2018 UK Corporate Governance Code, effective for accounting periods from 1 January 2019, continues to emphasise the importance of diversity, by:

- encouraging boards to think broadly about diversity in its different forms, including but not limited to gender diversity, and to ensure appointment and succession planning practices are designed to promote diversity;
- broadening the focus of the nomination committee, giving responsibility for overseeing the development of a diverse pipeline for succession to senior management; and
- encouraging reporting on actions taken to promote diversity and inclusion across appointments, succession planning and board evaluation, and on the outcomes in terms of progress on diversity.

Under the EU Directive on Non-Financial Reporting, UK companies are also required to include details on the diversity of the board of directors in annual reports from 2018 onwards.

⁷ The Investment Association. *Stewardship in Practice: IA Stewardship Survey*. November 2018.

⁸ Hermes Investment Management. *Diversity: Institutional Investors Rising to the Challenge*. September 2016.

⁹ Scrimgeour, Michelle. “Institutional investors and diversity: a shift towards sustainable change.” November 2017.

¹⁰ Fink, Larry. “2019 Letter to CEOs.” 2019.

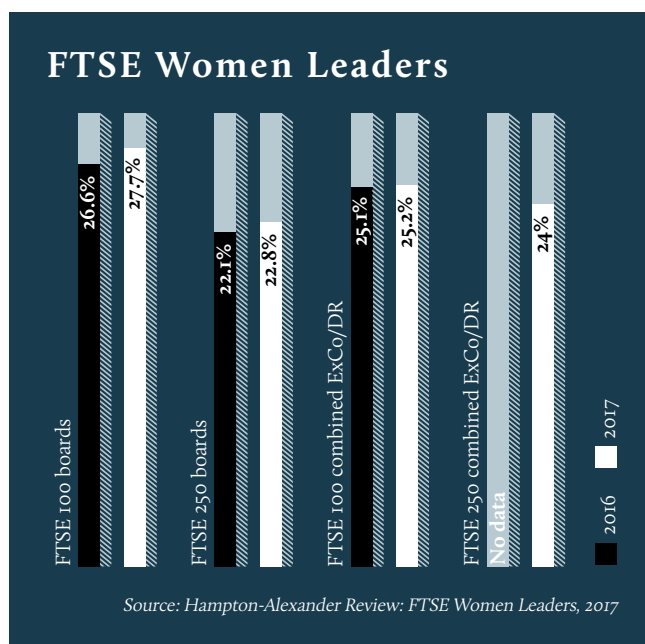
Key steps to achieve a diverse board

Given the high importance attached to achieving more diverse boards, there is a huge amount of research, reviews and various guidance documents on the subject. Many include recommendations and practical steps that companies can put into place, and the following key steps represent an amalgamation of these suggestions.

Set policies and goals

Achieving board diversity is dependent on a strong pipeline of diverse candidates coming up through today's organisations. Boards must ensure that inclusion and diversity are established as clear policies of the business. Policy objectives can then be reflected in specific goals; for example, targets to increase the percentage of women or members of ethnic minorities at board level or in senior executive roles by a set date. Other goals could relate to more junior recruitment, or improving the retention of women returning to work after maternity leave.

McKinsey's *Delivering Through Diversity* report recommends linking inclusion and diversity (I&D) to the growth strategy.¹¹ It states: "The I&D priorities must be explicitly defined based on what will drive the business growth strategy. Leading companies do this in a data-driven way." Companies with stronger I&D records can articulate the link between their I&D goals and specific business growth priorities. McKinsey's report notes: "This is often the result of investment in internal research to understand what aspects of I&D act as performance enablers for specific business metrics, such as productivity, customer retention, risk management or time to market, stemming from an understanding of how I&D links to specific value drivers such as customer insight, innovation, or decision making."



Goals should be measurable and linked to remuneration, for example, by tying the achievement of diversity targets to executive bonuses. Leading companies not only state their goals, but also commit resources to delivering the strategy. Business leaders must regularly communicate the importance of diversity—and achieving diversity goals—to the workforce. Not only does this help to encourage enhanced diversity, but also supports the creation of a diverse, inclusive culture.

Questions for the board to ask

- How effectively do current policies and goals capture your ambitions in relation to inclusion and diversity?
- What metrics could give you an insight into the link between I&D and business performance?

¹¹ Hunt, Vivian, Prince, Sara, Dixon-Fyle, Sundiatu and Yee, Lareina. *Delivering Through Diversity*. McKinsey & Company, January 2018.

Foster a diverse, inclusive culture

Developing an inclusive culture where talents from diverse individuals are recognised starts with the board. The Parker Review, for example, highlighted the need for commitment from chairs, board members and executives to developing and retaining the best talent, regardless of background.¹²

“There should be an expectation in business that the selection process is based entirely on merit. The ‘best’ person gets the job. Given the disproportionate number of men to women in senior roles, business should question the soundness of their meritocracies. I am pleased so many business leaders are asking this question and taking action to improve.”

Sir Philip Hampton, Chair, Hampton-Alexander Review, from the *2017 Hampton-Alexander Review on FTSE Women Leaders*¹³

An examination of the FTSE 100

- 1,050 director positions in total
- UK citizen directors of colour represent only about 2% of the total director population
- 85 individual directors of colour (four hold two Board positions)
- Total directors of colour represent about 8% of the total (compared to 14% of the UK population)
- 51 out of the FTSE 100 companies do not have any directors of colour
- Seven companies account for over 40% of the directors of colour
- Five out of the seven companies have headquarters historically located outside the UK
- Only six people of colour hold the position of Chair or CEO

Source: *The Parker Review Committee. A Report into the Ethnic Diversity of UK Boards, 2017*

As the Equality and Human Rights Commission (EHRC) has highlighted, developing a diverse, inclusive culture may require positive actions to encourage individuals from under-represented groups to apply for roles, or help them gain skills so that they can compete on merit on an equal footing with others.¹⁴ Such actions could include:

- reserving places on leadership and training courses to prepare individuals to apply for leadership roles;
- providing programmes for people in particular under-represented groups to help individuals manage the specific barriers faced by that group;
- providing opportunities for individuals to observe board meetings or to join networks that might expose them to board opportunities; and
- offering flexible working at all levels of the company and flexible career paths to help retain people from under-represented groups.

Questions for the board to ask

- How are you communicating your board’s commitment to I&D across the organisation?
- How are you identifying the individuals in your organisation who have significant potential but may face certain barriers?

¹² Parker, Sir John. *The Parker Review Committee. A Report into the Ethnic Diversity of UK Boards. Final Report, 12 October 2017.*

¹³ Hampton-Alexander Review, *FTSE Women Leaders. Improving gender balance in FTSE Leadership. November 2017.*

¹⁴ Equality and Human Rights Commission. *How to improve board diversity: a six-step guide to good practice. Updated February 2019.*

Make diversity visible: engage with the public, employees and other stakeholders

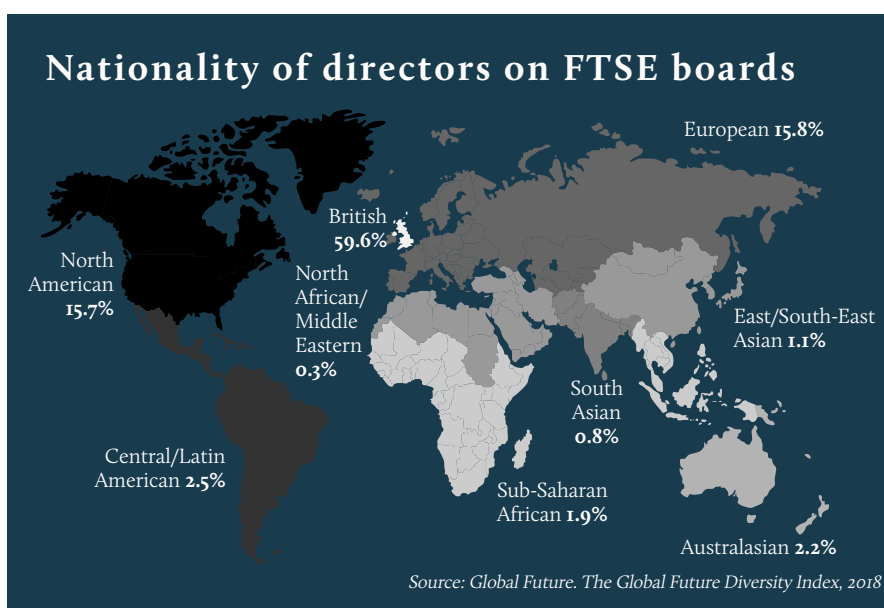
Transparency helps to drive change. The Parker Review recommended enhancing transparency and disclosure. It said: “A description of the board’s policy on diversity should be set out in a company’s annual report, and this should include a description of the company’s efforts to increase, amongst other things, ethnic diversity within its organisation, including at board level.”

However, the Financial Reporting Council’s report *Board Diversity Reporting*, based on reviewing the annual reports of FTSE 350 companies published as at 1 March 2018, found substantial quality variations: “At one end, a sophisticated understanding of diversity as the best utilisation of talent and a significant strategic issue is evident. At the other end, a lack of engagement, leading to a minimalistic, ‘tick-box’ approach.”¹⁵

The best companies set measurable objectives and are more knowledgeable about which initiatives are successful within their own organisations. A number of boards are increasingly discussing diversity as a much broader concept that encompasses a range of sources of difference, including social and educational background, disability and other characteristics.

As the EHRC highlights, annual reports should describe the work of the nomination committee, including the process it has used in relation to board appointments. This should include a description of the board’s policy on diversity, any measurable objectives that it has set for implementing the policy and progress on achieving the objectives.

Transparency on diversity goals and achievements can strengthen brand appeal to a diverse customer base, help to attract and motivate employees, and satisfy shareholder requirements. It can help to create a virtuous circle of diversity enhancement. For example, when companies become known for encouraging diversity—or leading executives have a reputation as “diversity champions”—that encourages approaches from more applicants. McKinsey research found that one CEO’s reputation as a male champion for diversity prompted a search firm to send him a qualified female board candidate proactively, even though he hadn’t initiated a search engagement with them.¹⁶



Questions for the board to ask

- How clearly does your corporate reporting articulate your actions to support I&D in your organisation?
- How does your reporting compare with peers? Could you benefit from being even more transparent about I&D initiatives?

¹⁵ Financial Reporting Council. *Board Diversity Reporting*. September 2018.

¹⁶ Huber, Celia and O'Rourke, Sara. "How to Accelerate Gender Diversity on Boards." *McKinsey Quarterly*, January 2017. www.mckinsey.com/featured-insights/leadership/how-to-accelerate-gender-diversity-on-boards.

Continually assess and develop workforce skills and nurture the talent pipeline

If boards are to become more diverse, developing a diverse talent pipeline is important. This starts with developing a clear picture of the current workforce (subject to any data gathering regulations), and understanding current and future skill requirements. Boards could also compare their own composition against that of peers to help identify whether they lack any skill sets or have weaknesses that could serve as red flags to investors. Tools like Diligent's Nomination & Governance application allow boards to see how they compare to their peers and to identify red flags that their investors may be raising related to their composition and diversity.

Nurturing the talent pipeline also involves:

- accessing a wider pool of potential recruits to help feed the start of the pipeline;
- identifying the qualities that indicate potential (such as independent thinking, initiative, honesty etc)—to help managers identify individuals who could progress in the organisation;
- developing the skills of leaders to help them manage in an inclusive manner;
- constantly looking out for unconscious bias in the selection and career development process;
- offering tailored programmes to support under-represented groups, for example, to help them build specific skills or increase confidence;
- providing mentors and sponsors—senior executives who proactively open doors for under-represented individuals with talent;
- managing career paths so that individuals with potential are appointed to roles with profit-and-loss responsibility—often a requirement for the most senior appointments;
- taking a longer-term view on the board-specific talent pipeline to nurture high-potential individuals.

Companies may ultimately need to stop looking for the “perfect” candidate for the board—that is, someone with previous board-level experience. As leadership advisory firm Egon Zehnder states: “An executive with functional or industry experience and high executive leadership potential can add value, whether or not she is a sitting CEO or director today. This executive potential is made up of four traits: curiosity, insight, determination, and engagement.”¹⁷ The firm advises boards to “pick for potential”. It says “Bet on potential expands the talent pool automatically and also contributes to boardroom success.”

Some innovative schemes are available to help develop talent. For example, the Future Boards Scheme, aimed at FTSE 350 companies, gives senior women the opportunity to gain 12 months' board experience. Run by the 30% Club UK, the UK Government and not-for-profit organisation Board Apprentice, the scheme enables participants take part in all day-to-day aspects of the board, although they have no voting rights and are not part of the formal decision-making process. The scheme could potentially be expanded in future beyond female candidates to improve broader diversity on boards.

Questions for the board to ask

- How could you access a wider pool of potential recruits to help feed your talent pipeline?
- In what ways could mentoring and sponsorship help to develop more junior talent more quickly?

¹⁷ Egon Zehnder. *Who's Really on Board? 2018 Global Board Diversity Tracker*. 2018.

Recruit with diversity in mind

“In the UK, our talent pool is changing as the composition of our society changes along with our customer base at home and overseas. The databases of a number of executive search firms demonstrate that a range of ethnically diverse eligible candidates, who could be considered for a number of job specifications in the boardroom, are available now. As time passes, this pool of talent will be enhanced and grow.”

Sir John Parker from *A Report into the Ethnic Diversity of UK Boards*¹⁸

Achieving diversity requires a willingness to look beyond current talent pools and familiar networks. It also involves:

- providing a clear brief, including diversity targets, to executive search firms;
- avoiding criteria that relate to subjective concepts such as “fit”;
- defining selection criteria in terms of measurable skills, experience and personal qualities;
- being open to the potential of first-time directors;
- looking beyond corporate candidates to consider appropriately skilled individuals from other spheres such as academia, law or non-profit sectors;
- ensuring consistent assessment procedures are followed throughout the selection process.

It is clearly essential to avoid discriminating against any groups during the recruitment process. For example, as the EHRC makes clear, it would be unlawful for a company to instruct an executive search firm to find a female non-executive director to improve the gender balance on the board, or to provide an all-women shortlist, as this would require potentially discriminating against better qualified men.¹⁹

But boards can expect executive search firms to address diversity needs. According to the 2018 Hampton-Alexander Review, 13 executive search firms qualified under the Enhanced Code of Conduct—having met the exacting performance criteria and best practice standards in gender-balanced selection for FTSE 350 boards.²⁰ For example, in the previous 12 months, at least one in three of their overall FTSE board appointments had gone to women. In addition, a Standard Voluntary Code of Conduct, signed by over 40 UK search firms, also promotes gender-balanced recruitment.

Questions for the board to ask

- How could your recruitment procedures be limiting the diversity of applicants?
- What new talent pools—outside of your sector—could you be accessing?

¹⁸ Parker, Sir John. *The Parker Review Committee. A Report into the Ethnic Diversity of UK Boards. Final Report, 12 October 2017.*

¹⁹ Equality and Human Rights Commission. *An inquiry into fairness, transparency and diversity in FTSE 350 board appointments.* March 2016.

²⁰ Hampton-Alexander Review, *FTSE Women Leaders. Improving gender balance in FTSE Leadership.* November 2017.

Provide education and training on diversity in leadership

Education and training on diversity—why it matters, how to encourage it and how to manage in a diverse and inclusive way—can help to embed I&D within the corporate culture and tackle unconscious bias.

According to a review of minority ethnic senior executive and board leaders in the UK conducted by the executive search firm Harvey Nash, 63% believed that unconscious bias of CEOs and leadership teams was a key reason for the lack of progress at board level; and one in four believed that bias and discrimination existed within their organisational culture.²¹

EY's three practical steps to take to ensure a smooth career path



Reflect

Explore what helps careers go smoothly for those who fit the cultural norm and replicate it for all. Identify potential obstacles for those who are different and remove these obstacles.



Talk

Educate everyone, especially those with significant leadership roles, in the challenges relating to race diversity and ensure they practise articulating those challenges.



Watch

Help identify diverse rising stars who will benefit from developing their career capital.

Source: The Parker Review Committee. A Report into the Ethnic Diversity of UK Boards, 2017

The 2017 Parker Review suggests that companies could introduce a cultural and behavioural change programme to equip all teams with skills and awareness to be inclusive leaders and to achieve a more diverse senior leadership.²² This may include integrated learning programmes aligned to the organisation's priorities, to promote a culture of inclusion that enables all people to succeed. In addition, the Parker Review advocates reverse mentoring, whereby executive management is paired with employees of minority ethnic backgrounds, increasing knowledge and understanding on both sides.

Egon Zehnder also recommends training the board for success: "It is not enough to simply add fresh faces to a board. Chairs and current directors must also support the integration of

new directors after their appointment, both by teaching them the norms of the board and by allowing for the norms of the board to change. New directors should be encouraged to speak out and challenge the status quo."²³

Questions for the board to ask

- How can you assess the extent and impact of unconscious bias in your organisation and what training may be needed to address it?
- What more could be done to help new board members perform effectively and feel confident about expressing their opinions?

²¹ Harvey Nash. *The Ethnicity Gap: Understanding Barriers to the Boardroom for Ethnic Minorities*. July 2016.

²² Parker, Sir John. *The Parker Review Committee. A Report into the Ethnic Diversity of UK Boards. Final Report, 12 October 2017*.

²³ Egon Zehnder. *Who's Really on Board? 2018 Global Board Diversity Tracker*. 2018.

Conclusion

Diversity in the boardroom is now seen as good business practice—supporting enhanced decision-making, market understanding and employee engagement. Regulators and investors see the value in board diversity, and are willing to engage on the issue where weaknesses are identified.

Increasing diversity isn't an overnight task. It takes commitment, clear policies and goals and investment in building the talent pipeline. However, leading companies are making progress, particularly in relation to gender, showing that change can happen when business leaders back up strategic intent with practical actions.

Equip your board with the right tools

- How does your board composition compare to your peers? What skill sets is the board lacking? What conflicts of interest might your investors have uncovered? Diligent provides quick access to this information to help board members identify governance red flags raised by shareholders and activists.
- The Nominations and Governance application in the Diligent software solution also puts the power of candidate search at the board's fingertips. Nominating and governance committees can search Diligent's extensive database of board members based on their desired criteria and diverse characteristics.
- Depending on the detail and functionality required, the light version of the Nominations application, Diligent's Director Network, is accessible in the Diligent Boards iPad app and there is an option to upgrade to the full Nomination and Governance application. The former provides instant access to the same information that is used by proxy advisers—an overview of individual and company profiles, with basic search capabilities.
- The full Nomination and Governance application provides many more insights into aspects such as board composition and effectiveness, boards' aggregate and members' expertise, directors' networks, and committee members and their networks. Users can set up a customisable watchlist to support succession planning. The Nomination and Governance application enables companies to independently and proactively build highly effective boards, with the right composition, while at the same time reducing any reputational, governance and activism risks.

For more information on this module and how Diligent is pioneering modern governance, go to:

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The path to board diversity

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