Briefing

Diversity and Inclusion must add up for Successful Governance

INSTITUTE OF DIRECTORS IN IRELAND

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It has been recognised that one of the most effective ways to enhance corporate governance is by having a diverse board. In the past decade many organisations have worked to create diversity in their boards so that they are more reflective of society and have a range of perspectives, insights and challenge needed to support fairness and good decision making.

However, increasing demands for diversity (for example, gender and race) from regulators and stakeholders reveal that many companies are slow to create diversity in their top ranks.

Need for diversity

Trust and stability

The value and increasing importance placed on diversity in the workplace was recently highlighted when Lloyds Banking Group Plc's measures to improve staff diversity were called a "credit positive".[1] Those measures included a "Race Action" plan, that focussed on promoting more black employees to senior roles, developing a race education programme and, committed to drive cultural change. While it has been acknowledged that gender diversity on boards can be a credit positive – because of the scope for diversity of opinion – the express link by a rating agency between a company's stability and racial diversity measures marks a new departure.

1 In Moody's Investors Service Report.

The Black Lives Matter protests all over the world have been prompting many public companies including Lloyds to review their approach to diversity and inclusion. Earlier this year, Institutional Shareholder Services, one of the most influential shareholder advisers, urged American companies to disclose the ethnicities of their senior directors.

Stakeholders and community

Investors want companies to go beyond tokenism and to work towards board parity. Asset managers have taken a strict line on board diversity, voting at companies' AGMs against signing off on financial statements where, for example, women do not account for at least 25% of the directors on the board.

There has been increased scrutiny by asset managers, of companies' behaviour during the pandemic, who have made it clear that they want companies to meet the UK's Hampton-Alexander targets of gender diversity.[2] Investment Association has indicated that its voting advice service (widely used by large investors) would issue a "red-top" warning (its highest level of warning) to companies which are not meeting investor expectations on diversity. There is also an increased community expectation of gender balance on boards and in particular on state boards, reflected by the Irish Government's recent publication of the Annex on Gender Balance, Diversity and Inclusion to supplement the existing Code of Practice for the Governance of State Bodies 2016.

The value of diversity and inclusion

Diversity can bring several benefits to an organisation including:

- more informed and diverse decision making (avoiding group think), diverse perspectives, diverse experience, increased innovativeness and critical thinking that comes from inclusion;
- demographically diverse boards which are more likely to challenge the CEO;
- it's use as a means to ensure fairness and rebuke discrimination;
- the creation of role models for others;
- building a deeper understanding of and access to desirable customer bases and markets; and
- incorporating new perspectives and generate learning, industry knowledge, strategy and financial experience.

2 The Hampton-Alexander Review is an independent, business-led initiative supported by the UK Government, building on the work of the Davies Review to increase the number of women on the FTSE 350 boards. This Review, which is in its final year, has a 33% target for women in senior leadership positions in the FTSE 350 by the end of 2020.

Targets, quotas and disclosure requirements

The use of quotas to achieve diversity is controversial and can be counterproductive if they mask the fact that structural changes necessary to change organisational culture have not been implemented. This can mean that representation from key focus areas – such as, race, colour, gender, LGBT+ or disability – might never rise above prescribed quotas and become ceilings on representation.

The key question is whether the quotas have an overall positive or negative effect on board and company performance and under what conditions. Quotas can be an effective means of delivering accelerated change but other measures are available.

In terms of reporting on diversity, Ireland transposed certain EU requirements on non-financial reporting[3] by way of the EU (Disclosure of Non-Financial and Diversity Information by Certain Large Undertakings and Groups which require the directors of large traded companies to include in the directors' report a "diversity report" on its diversity policy, including a description of the policy, its objective, implementation details and the results of that policy.

Processes and strategies

It is not enough for an organisation to hope that a diversity and inclusion initiative will solve this lack of diversity and the inequality that underlies it. Inequality is a practice that needs to be addressed and translated into changes in behaviour, procedures and attitudes.

Many boards could benefit by including people with skills more diverse than specific technical skills. Proportionality is about adapting selection criteria and appointment processes for the particular position and its responsibilities and understanding the levels of risk arising from particular selection processes. Although there is no "one size fits all" approach to addressing diversity on boards there are some core areas and practices that can be considered when developing strategies to achieve balance.

Organisations need to be mindful of the essential dimensions to a high performing board, from functional and industry expertise to behavioural attributes which lead companies to recruit boards that are diverse not only, for example, in gender or race, but also in skills which will better equip a board to execute its functions. Companies may want to consider a wider definition of diversity to include experience, skills, perspectives, qualities and behavioural attributes, behavioural and interpersonal characteristics needed by the board and to be mindful to:

> ***Source talent:*** recruit, mentor and promote a diverse range of candidates at every level of the organisation. Boards are not selecting the best person for the job if they are merely looking in their own social networks, often likely to be composed of others of similar race, gender and socio-demographic.

3 Contained in EU Directive 2014/95/EU

Start early: open, transparent and well-timed appointment or selection processes are likely to achieve a wider and more diverse pool of potential candidates. Commence recruitment processes well in advance and increase publicity for board vacancies to attract a wider pool of potential candidates.

Select objectively: boards can consider whether to implement quotas or affirmative action programmes to increase their diversity. Alternative measures might include widening the definition of the qualifications that the ideal candidate would have, including a broader combination of demographics, skills, experience, race, age, gender, educational and professional background and other relevant personal attributes. An objective, transparent method for selecting directors is essential if new appointments are to be made on merit.

Integrate: ensure that directors are fully integrated into their boards so that they can reach their potential to increase board effectiveness, by establishing a strategic plan for board succession that includes discussions for diversity.

Inclusion and diversity

In addition to diversity, business leaders need to prioritise inclusion and ensure equal access of all groups of employees to training, professional development, networks, nominations for promotions and professional opportunities. Such inclusiveness leads to increased information sharing and participation in decision-making. Diversity is counting the numbers whereas inclusiveness is about making those numbers work.

It is crucial to have a culture that values, rewards, supports and fosters individual differences, to create an environment where everyone has an opportunity to advance and in which it is possible that anyone could rise to senior leadership positions. Otherwise, there is a risk that some employees could mask their differences to fit in with the majority, which reduces their value within the organisation.

Times of crises

Between disruption caused by COVID-19 and constraints imposed to contain its spread, companies are faced with unprecedented levels of uncertainty. Instead of looking at such disruptions as an opportunity to make their boards more diverse, companies may be tempted to respond to uncertainty and financial pressure by dropping the diversity and inclusivity focus. With the impact of social inequality being magnified by the pandemic, it is even more important to focus on diversity and inclusion.

Moreover, reliance is placed on directors to take actions in response to this evolving pandemic that demand, on an almost daily basis, new measures which impact their business. Any crises will give the opportunity to evaluate how organisational processes have to adapt. Research has shown that when people are making decisions in a stressful situation, fast and effortless biases can dominate over slow and demanding consideration and debate. Organisations are less likely to make rash short term decisions and more likely to be innovative in the way in which they deal with crises if they can seek input from a diverse board who can approach problems from a variety of perspectives.

Comment

Diversity must be seen as a strategic imperative to address unfairness and inequality and as one that leads to better decision making and board effectiveness. According to the 2019 Hampton-Alexander Review on Improving Gender Balance in FTSE Leadership:

> *"In 2019, our dataset continues to show a significant link between diversity and financial performance, with companies in the top quartile for executive team diversity 15-24% more likely to outperform their national industry median EBIT margin than their bottom quartile peers."*

Dedicated diversity and inclusion programmes are only part of the solution to the issue. Succession planning is also important because it allows boards to consider the objective of diversity within the context of a company's operation. Leaders must set the tone and the standards for behaviour in organisations. Policies and training programmes cannot compensate for leaders and colleagues who ignore or even endorse behaviour that discriminates, marginalises and excludes. Whether the focus is on gender, race, sexual orientation, physical or mental ability, religion or age, organisations need to continue to step up on diversity and inclusion and address the underlying inequality.

Further information is available from




Mary Brassil
Partner
+353 1 607 1279
mary.brassil
@mccannfitzgerald.com

Audrey Byrne
Partner
+353 1 611 9125
audrey.byrne
@mccannfitzgerald.com

David Byers
Partner
+353 1 607 1365
david.byers
@mccannfitzgerald.com

Garreth O'Brien
Partner
+353 1 607 1489
garreth.obrien
@mccannfitzgerald.com

Alternatively, your usual contact in McCann FitzGerald will be happy to help you further.

IoD
INSTITUTE OF DIRECTORS
IN IRELAND

Institute of Directors in Ireland, Europa House, Harcourt Street, Dublin 2
01 411 0010 | info@iodireland.ie | www.iodireland.ie