NATIONAL EMPLOYMENT SAVINGS TRUST

Gender imbalance in corporate boards in the EU

A response to the European Commission's public consultation

Summary

NEST supports a flexible system of corporate governance that puts the onus on company boards to explain how they are increasing gender diversity at the most senior levels. We believe that this will lead to higher standards of corporate governance that will be in the long-term interests of shareholders. We would not expect to see legislation introducing Europe wide quotas at this stage.

Initially, we would like to see efforts of the European institutions concentrated on improving reporting and transparency of corporate boards across the EU. Improved disclosure will increase market efficiency as better informed shareholders will be better placed to act on poor corporate governance.

However, larger shareholders and the agents acting on their behalf must be encouraged to take appropriate action. If they don't act then it is our view that the European Commission will be left with little alternative but to take additional measures.

The evidence on the number of women that currently sit on boards of EU corporations suggests that self regulation has been largely ineffective to date. However, since the financial crisis of 2008 there appears to have been a shift in the attitudes of shareholders, governments and corporations themselves which shows no signs of losing momentum.

We think the commission should monitor the situation closely and revisit plans for legislation in three to five years if there hasn't been a marked improvement.

We agree with the commission's analysis that greater board diversity – particularly more gender diversity – leads to better financial performance because of:

- diversity of thought, reduction of groupthink, and increased innovation
- decisions that better reflect and respond to client and customer bases
- utilisation of the entire corporate talent pool
- improved corporate governance and corporate ethics.

We think that 30 per cent is a reasonable initial target for representation of women on corporate boards. Evidence and analysis from diverse fields, such as organisational dynamics, social psychology and traditional financial analysis suggests that 30 per cent is where the contributions of a 'minority' group become valued. It's at this level that the impact on corporate performance is most noticeable.

We are primarily interested in improving performance in large listed companies as we're predominantly a global index investor. However, there is no reason why this target shouldn't apply to other companies.

Introduction

From October 2012 onwards, employers in the UK will have a statutory duty to enrol some or all of their workers into a pension scheme that meets or exceeds certain legal standards. They are also likely to make minimum contributions for these workers.

NEST is a defined contribution pension scheme that's available to any UK employer who wishes to use it to meet their employer duties. It's been specifically designed for people who may not have saved in a pension scheme before and has a public service obligation to accept any employer that wishes to use it to meet their new duties.

More information about NEST can be found at: **http://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/key-facts-myths,PDF.pdf**

NEST is forecast to have significant investments in companies across Europe. As a long-term investor on behalf of potentially millions of low to moderate earning workers in the UK, ensuring that corporations are managed and governed effectively is an important part of our mandate. We therefore welcome the European Commission's consultation on gender imbalance on corporate boards.

Safeguarding investment performance

The composition and role of corporate boards has been a matter of particular focus for the UK government, asset owners, pension funds, trade bodies and social partners since the financial crisis in 2008. It's a space where we feel there are great opportunities for improvement in all EU member states.

We're also pleased to note that the terms of the debate - as set out in *Women in economic decision making in the EU: Progress report* - focus exclusively on the economic imperatives of board diversity, rather than as an exercise in social engineering. NEST Corporation's mandate when investing on its members' behalf is to improve long-term risk-adjusted return for scheme beneficiaries. Alongside this we will continue our work to ensure that we reflect an evolving view of our members' interests and changing social attitudes.

Why improved corporate governance matters

NEST Corporation is committed to developing a suitable investment strategy for its members that's based on evidence. To this end we've conducted an extensive programme of research and consultation to form the basis of our approach.

Our research has led to a strongly evidenced belief that ignoring corporate governance in our investment process would be a failure in our duty to act in our members' best interests. We believe that poor corporate governance leads to poor performance of corporations. Poor performance of corporations results in lower or less sustainable returns for NEST's members and can also result in less efficient global markets.

On the basis of this belief, we see part of NEST's role as an asset owner is to influence regulators and policymakers in order to provide the best regulatory environment to support economic growth and sustainable corporate performance. We're committed to working with fund managers, other pension funds, trade bodies and social partners to achieve this.

To support this goal NEST has signed and is a vocal supporter of the Financial Reporting Council's UK Stewardship Code, which aims to improve the way companies and shareholders work together to improve corporate performance. NEST is also a signatory to the United Nations-backed Principles for Responsible Investment (UNPRI), which encourages consistent standards for responsible investment around the world.

The importance of diversity on boards

This response is based on a great many studies from the UK and overseas about how corporate boards operate most effectively. The overwhelming majority conclude that boards drawn from a narrow section of society are less effective than boards that include members with a variety of experiences and backgrounds.

The evidence consistently suggests that greater board diversity – particularly more gender diversity – leads to better financial performance, measured as return on equity and return on capital employed.

Studies suggest causality between financial performance and diverse boards may be explained by:

- diversity of thought, reduction of groupthink, and increased innovation
- decisions that better reflect and respond to client and customer bases
- utilisation of the entire corporate talent pool
- improved corporate governance and corporate ethics.

Evidence of improved financial performance

As institutional investors understanding the underlying drivers of corporate performance is an essential element of managing risk and meeting our investment objectives. There is a large and growing body of evidence that demonstrates the positive impact that greater gender diversity in senior positions has on corporate performance:

- Analysis conducted by Mckinsey in 2007 showed that European-listed companies with the highest levels of gender diversity outperformed their sector peers. In terms of stock price change they outperformed them by 17 per cent between 2005 and 2007 and by more than 1 per cent in terms of return on equity in the same period.[1]
- A study by Catalyst in 2007 of US Fortune 500 companies found that those with the highest number of women on their corporate boards outperformed companies with the lowest number or no women on their boards by 53 per cent in terms of return on equity.[2]
- The same study showed that companies that were in the top quartile in terms of percentage of women on their corporate boards outperformed companies in the bottom quartile by 66 per cent in terms of return on invested capital. The same companies also outperformed their less diverse peers by 42 per cent in terms of return on sales.
- A 2007 study in Finland examined limited liability companies that employed at least 10 people in 2003. Companies with a majority of women on their corporate boards showed adjusted return on assets of 14.7 per cent, compared to 11.5 per cent where the majority was male.[3]
- A 2011 Australian study found that over a three-year period, ASX500 companies with women directors delivered 6.7 per cent higher return on equity than those without any women on their boards. Over a five-year period the figure was 8.7 per cent higher.[4]

1 McKinsey & Company (2007) 'Women Matter: Gender diversity, a corporate performance driver'
2 Catalyst (2007) 'The Bottom Line: Corporate Performance and Women's Representation on Boards'
3 Kotiranta, Annu, Kovalainen, Anne and Rouvinen, Petri (2007) 'Does Female Leadership Boost Firm Profitability?' No 1110, Discussion Papers, *The Research Institute of the Finnish Economy*
4 Reibey Institute (2011) 'ASX 500 – Women Leaders'

In addition to improved performance there is also evidence to suggest that a higher degree of diversity leads to lower levels of share price volatility and reduced chance of business failure. The Davies report cites a Leeds University Business School study that shows that having at least one female director reduces a company's chance of insolvency by 20 per cent and that having two or three female directors lowers the chances further.[5] A 2009 report into the performance of companies in the French CAC 40 stock exchange index showed that the higher the proportion of women in senior positions, the lower the fall in share price during the financial crisis of 2008.[6]

Reducing groupthink and increasing innovation

Evidence from behavioural psychology suggests that more diverse backgrounds, experience and qualifications, reduce uniformity and improve the quality of decision making on boards.[7, 8, 9]

In addition, numerous studies show that embracing diversity at corporate level and throughout an organisation is likely to lead to greater innovation in products and business processes. One example is Pepsi, which estimated that in 2004 about 1 per cent of their 8 per cent revenue growth came from new products inspired by diversity efforts.[10]

In his 2011 report Lord Davies notes the increased focus on the debate about gender differences in risk preference and behaviour. Studies suggest there appears to be a link between gender and approaches to risk.[11] Within the US mutual fund industry, research in 2009 found that while performance between funds run by men and women is similar, women tend to be less hyperactive in their trades and display more cautious and consistent investment styles compared to men.[12]

Another study 10 years earlier points to different appetites for risk and the suggestion that women may be more risk-aware, as opposed to risk-averse.[13] This may translate into different decisions taken by boards where women represent a significant proportion.

Reflecting and responding to markets

Evidence collated by Mckinsey points to the fundamental role of women as consumers in the global economy. In Europe they estimate that women are the driving force behind 70 per cent of household purchases while accounting for only 51 per cent of the population.

This is true even in industries where buyers are traditionally male. They point to examples in Japan where women influence 60 per cent of purchasing decisions for new cars, and Europe where women account for 47 per cent of PC users.[14]

As Gord Nixon, CEO of Royal Bank of Canada stated in 2010: '*There's no reason a man can't do a better job of serving a female customer, or a Chinese Canadian can't do a better job of serving an East Indian customer, but as an organization, we need to ensure that our makeup reflects the overall makeup [of the customer base]. It just makes good business sense*.'[15]

5 Davies, Evan Mervyn (Lord Davies of Abersoch) (2011) 'Women on Boards'
6 Ferrary, Michael (2009) 'CAC 40: Les entreprises feminisees resistent-elles mieux a la crise boursiere?'
7 Ellemers, Naomi and Rink, Floor (2010) 'Benefiting from deep-level diversity: How congruence between knowledge and decision rules improves team decision making and team perceptions', *Group Processes & Intergroup Relations*
8 Page, Scott E (2007) 'The Difference: How the power of diversity creates better groups, firms, schools, and societies' Princeton University Press.
9 Payne, John W (2009) 'Investment Committee Decisions: Potential Benefits, Pitfalls and Suggestions for Improvement'
10 Hymowitz, Carol (2005) 'The New Diversity' The Wall Street Journal
11 Hancock, Matthew and Zahawi, Nadhim (2011) *Masters of Nothing: How the crash will happen again unless we understand human nature.* Biteback Publishing.
12 Niessen, A and Ruenzi, S (2009) 'Sex Matters: Gender Differences in the Mutual Fund Industry'
13 Byrnes, J. P., Miller, D. C. and Schafer, W. D. (1999) 'Gender differences in risk taking: A meta-analysis' *Psychological Bulletin*, Vol 125(3)
14 McKinsey & Company (2010) 'Women Matter: Women at the top of corporations: Making it happen'
15 Kline, Alan (2010) 'Human Resources: The Business Case for Diversity' *American Banker*

Utilising the entire talent pool

In the US and Europe 60 per cent of all graduates are women. In many European countries women make up close to half the labour force.[16] A failure to tap into this pool of talent can be characterised as a business failure.

Research suggests that women who are on private boards of directors in Europe are more highly qualified than their male counterparts. The theory that there is insufficient female talent available to choose from is losing credibility. The evidence increasingly shows that there is an available pool of talented female directors, but companies are failing to look beyond the usual collection of candidates.[17]

There appear to be a number of reasons for reluctance to utilise existing talent, but studies would suggest that perceptions of women are most likely the problem. For example, a study in 2007 reports that CEOs are afraid to appoint women who are not already directors, yet they are less concerned if a man doesn't have that experience.[18]

A 2009 study in Finland found that while female board members reported that gaining experience and demonstrating credibility was important to increasing the presence of women on boards, changing the attitudes of senior men was still considered the key element to change. (Pesonen, Tienari & Vanhala, 2009).

Achieving improved corporate governance

An Association of British Insurers report on board effectiveness states that boards with better gender balance pay more attention to audit and risk oversight and control.[19]

A 2002 study supports this. It showed that three quarters of boards with women on them explicitly identified criteria for measuring strategy, compared to less than half where the boards were all male. Of boards with three or more women, 94 per cent explicitly monitored the implementation of corporate strategy, compared to only two-thirds of all-male boards.[20]

The Davies report found that UK FTSE 100 companies with a greater proportion of women on their boards adopted governance recommendations stemming from the Higgs review[21] earlier than boards with less gender balance. The report also points to research conducted by the Harvard Business School that suggests that women appear to be more assertive on certain important governance issues, such as evaluating their own board's performance.

Diversity – social and cognitive

As set out above there is a sound economic and business case for increasing gender balance on corporate boards across the EU.

We believe that the rationale behind this is as much an issue of cognitive diversity as well as social diversity. Cognitive diversity takes into account factors including experience, training, background and education.

We recognise that diversity of social identity, that is, gender, ethnicity, sexuality and so forth, may correlate with cognitive diversity but they are not necessarily the same thing.

16 Eurostat (2012) 'Employment rate by sex, age group 15-64'
17 Singh, V., Terjesen, S. and Vinnicombe, S. (2008) 'Newly appointed directors in the boardroom: How do women and men differ?' *European Management Journal, Volume 26*
18 Peterson, C. A. and Philpot, J. (2007) 'Women's Roles on U.S. Fortune 500 Boards: Director Expertise and Committee Membership' *Journal of business ethics, Volume 72, No. 2.*
19 Association of British Insurers (2011) 'Report on board effectiveness: Highlighting best practice: encouraging progress'
20 Brown, D., Brown, D. and Anastasopoulos, V. (2002) 'Women on Boards: Not just the Right Thing . . . But the "Bright" Thing'
21 Higgs, D. (2003) 'Review of the role and effectiveness of non-executive directors' *Department for Trade and Industry*

In addition, it's becoming increasingly well-recognised that biological sex and the social construction of gender are not the same.[22] The focus on gender balance therefore shouldn't become a reductive argument that women and men are predisposed to act in a certain way.[23] However, the close association of gender and sex and the demands of conforming to sex-gender stereotypes mean that both the female sex and feminine gender are likely to be treated as if they are the same.

We therefore recognise that gender, ethnicity and sexual orientation for example, provide useful proxies when organisations are considering ways to improve diversity of thought and experience and looking to set targets or quotas for improving diversity on corporate boards.

Responses to specific questions

1. How effective is self-regulation by businesses to address the issue of gender imbalance in corporate boards in the EU?

The data on the number of women on the boards of corporations across the EU suggests that self-regulation has been largely ineffective to date. However, since the financial crisis - certainly in the UK - there appears to have been a shift in the attitudes of shareholders, government and corporations themselves, which shows no signs of losing momentum.

For example, in 2010 the UK Government asked Lord Davies to review barriers preventing more women reaching the boardroom. Twelve months after Lord Davies' first report, progress from a low base, already appears to have been made to meet a proposed target of 25 per cent of women on FTSE 100 corporations by 2015.

In FTSE 100 companies, the current state of play is:

- female representation on boards now stands at 15.8 per cent[24] (up from 13.5 per cent in 2010)[25]
- 18 boards have over 25 per cent female representation, with Diageo leading the way with 44 per cent
- all-male boards stands at 10 (down from 15 in 2010).

In the FTSE 250, the situation is less positive:

- female representation on boards now stands at 9.8 per cent (up from 7.8 per cent in 2010)
- all-male boards stands at 110 (44 per cent, down from 52.4 per cent).

In addition, the Financial Reporting Council has recently amended the UK Corporate Governance Code to require all listed companies to establish a policy in relation to boardroom diversity and annually disclose progress made to achieving these objectives.

The 30% Club is another UK initiative that brings together chairs of UK boards and investors committed to increasing the proportion of female directors. Its members have declared their voluntary support for a goal of 30 per cent of board positions being occupied by women by 2015. It now has an investor group sub-committee, a steering committee and 45 FTSE chairmen fully signed up.

These recent initiatives suggest that change is possible without statutory intervention where there is clear political and corporate will.

22 Fine, Cordelia (2010) Delusions of Gender: *The real science behind sex differences.* Icon Books.
23 Broadbridge, Adelina and Simpson, Ruth (2011) '25 Years On: Reflecting on the past and looking to the future in gender and management Research' *British Journal of Management, Vourne 22.* Blackwell Publishing
24 The Professional Boards Forum (2012) 'BoardWatch'
25 The Professional Boards Forum (2011) 'BoardWatch'

In our view the jury is still out as to whether or not self-regulation is possible across the EU. We note, however, that markets and market participants, such as ratings agencies, are more likely to reward corporations that take these matters seriously as the evidence of market advantage that greater diversity brings is more widely recognised.

Overall, we sense that the debate in the UK at least appears to have moved in the last two years, from asking why the issues are relevant to determining how change can be achieved. There is plenty of anecdotal evidence from the responsible investment community that this is a topic that has found a central place in mainstream discussions at board level between companies and investors. We would hope that a similar shift is being seen across the EU following the increased focus by European institutions.

2. What additional action (self-regulatory/regulatory) should be taken to address the issue of gender imbalance in corporate boards in the EU?

In general we support a flexible system of corporate governance that puts the onus on company boards to explain how they have evolved a high standard of governance in the long-term interests of their shareholders. Initially we would therefore like to see the efforts of European institutions be concentrated on improving reporting and transparency of corporate boards across the EU.

We support the mantra attributed to Peter Drucker, writer, professor and management consultant, that 'what gets measured gets done.' The primary focus for the short-term should be to require companies to provide better information to their shareholders. Companies should disclose their efforts to improve their employment policies to ensure talent is able to rise to the top. They should also disclose the steps they're taking to ensure their corporate boards include more women. If they're not achieving adequate diversity throughout the company, boards need to explain why not.

We believe that the lack of progress towards greater diversity throughout member states could be at least partially overcome through principles and guidelines within a 'comply or explain' regime, rather than taking a rules-based approach which may lead to unforeseen and unintended consequences.

Before legislation is considered, corporations should be given a final opportunity to improve failings in their governance structures. Shareholders and regulators can help by demanding better information and engaging with corporations to help them change. For example, shareholders, their fund managers and other agents responsible for voting, could incorporate specific policies related to gender balance within their governance voting policies. NEST would be happy to assist the commission in drafting guidance or providing examples of best practice in this area.

We think the commission should monitor the situation closely and revisit it in three to five years if there hasn't been a marked improvement.

3. In your view, would an increased presence of women on company boards bring economic benefits, and if yes which ones?

Yes, as set out above, NEST believes the evidence for the benefits of greater gender diversity on boards is overwhelming. While we are mindful of the limitations of some methodologies employed, we cannot ignore the plain fact that report after report consistently shows improved performance by companies with more women on their boards in terms of return on sales, return on capital and return on equity.

The economic and business case for addressing the gender imbalance in the current structures of companies' boards was the most compelling outcome of Lord Davies' review, '*Women on Boards*'[26] in February 2011. It moves the debate away from a social issue to an urgent business imperative.

26 Davies, Evan Mervyn (Lord Davies of Abersoch) (2011) 'Women on Boards'

The evidence shows that companies with more women on their boards experience better financial performance due to:

- better decision making
- increased innovation
- utilisation of the entire talent pool
- decisions that better reflect what companies' customers want
- improved corporate governance.

Of these we would highlight the improvement in corporate decision-making that gender diversity can bring and the responsiveness of corporations to their customers.

Equally, there are many consequences of a lack of diversity on board effectiveness. These include a lack of appropriate representation and insight into a company's customers, workforce and geographic footprint, all key to successful delivery of strategy.

4. Which objectives (e.g. 20 per cent, 30 per cent, 40 per cent, 60 per cent) should be defined for the share of the underrepresented sex on company boards and for which timeframe? Should these objectives be binding or a recommendation? Why?

NEST is a strong proponent of the evidence and analysis provided by behavioural finance and psychology when it comes to decision making – be it about whether to save for a pension, or how much risk to take. In light of this, we agree with the body of evidence that suggests 30 per cent is the level where the contributions of a 'minority' group become valued in their own right as representatives of that group.

Studies on the number of people required to challenge group orthodoxy suggest that three women are required to change boardroom dynamics.[27] The previously cited McKinsey report shows that once a level of 30 per cent of women at board level is attained, the 'diversity bonus' jumps markedly.

We think that 30 per cent is a reasonable initial target for representation of women on corporate boards, rather than a binding quota.

In terms of timescales, it is difficult to see how a one-size-fits-all approach can be applied across Europe when different states are at such different positions. For example, Scandinavian member states will start from a significantly higher base than other member states. We would expect share owners and European institutions to recognise the diversity of member state experience and set stretching targets accordingly. In the first instance, a recommendation may provide a suitable means of improving performance across the EU.

Looking beyond the EU, Norway has - in terms of achieving greater plurality within corporate boards - been a success story by having reached 40 per cent in a relatively short period. Our note of caution would be that while progress in Norway has been rapid due to the imposition of a statutory quota, the same approach may not be suitable for all member states.

The UK's approach based on reporting, transparency and greater oversight by shareowners and regulatory authorities may prove equally effective. The Davies report for example sets a target of 25 per cent by 2015 with an aspiration of 30 per cent shortly afterwards. NEST supports the approach taken in the UK but recognises that failure of self-regulation will undoubtedly increase calls for legislative intervention which will be difficult to resist.

27 Societe Generale (2011) 'Getting the Right Women on Board'

5. Which companies (e.g. publicly listed / from a certain size) should be covered by such an initiative?

NEST is primarily interested in improving performance in large listed companies as we're predominantly a global index investor. For example in our shareholdings in the UK we consider that scrutiny should be applied for all premium listed FTSE companies, not just the FTSE100. We suspect that as the benefits of board diversity in larger companies become clear, private and smaller companies will look to take on these lessons for their own boards.

6. Which boards / board members (executive / non-executive) should be covered by such an initiative?

Experience in Norway suggests that while 40 per cent has been achieved, this has been generally due to an increase in female non-executive board members. The role of non-executive directors is to constructively challenge and contribute to the development of corporate strategy; scrutinise performance, monitor financial controls and systems of risk management; and appoint, remove and set the remuneration of executive management. In our view, because of these essential roles in corporate governance, increasing gender balance on boards through the increase of female non-executives will go a long way to improving overall corporate performance.

In addition, NEST believes that targets for increased diversity should also recognise the importance of improving diversity of directors occupying finance, operation and CEO roles. The proportion of female directors in these roles remains low across member states and we see benefits for increasing diversity in all of these roles. We believe this will lead to enhanced corporate performance and increase the available talent pool for non-executive positions on other corporate boards. We recognise that increasing board diversity through executives – rather than non-executives - may take more time. This is because most boards often only have one or two executive board members and opportunities are therefore likely to be more constrained.

7. Should there be any sanctions applied to companies which do not meet the objectives? Should there be any exception for not reaching the objectives?

Improved disclosure will increase market efficiency as better informed shareholders will be better placed to act on poor corporate governance. If disclosure is improved we believe the market will provide the ultimate sanction. Companies that don't meet diversity objectives will suffer poorer performance, lower investment and regular shareholder challenges at AGMs.

One practical example of how shareholders can demonstrate to the companies which they invest in, the importance they place on diversity in corporate boards is through how they vote at AGMs. They can also demonstrate their views through the policies and guidelines they make available to investee corporations. NEST's responsible investment partner, The Co-operative Asset Management, has recently changed its voting policy in relation to board diversity. In line with the recommendation set out in the Davies review of 2011:

'*All chairmen of FTSE 350 companies should set out the percentage of women they aim to have on their boards in 2013 and 2015. Chairmen should announce their aspiration goals within the next six months (by September 2011).*'

The Co-operative Asset Management voting policy now reads:

'Investee companies who hold their AGMs after this date will be assessed as to whether they have made a public statement of aspirational levels of women on their boards, as per Lord Davies' recommendations.

The Co-operative Asset Management (TCAM) will, in the first instance, abstain on the re-election of the Chairman of the Nomination Committee, should a company fail to disclose such an aspiration or fail to elect any women to an all male board.

Should a company not put forward all its directors for annual re-election, we will abstain on the re-election of the Chairman or members of the Nomination Committee – dependent upon who is put forward for re-election. In applying this policy TCAM will remain mindful that this is a multi-faceted topic and consequently will adopt a pragmatic approach, analysing on a case-by-case basis several factors, such as the length of tenure of the Chair of the Nomination Committee and the merit of any explanation why aspirations or appointments have not been forthcoming. We will also take into account membership of the 30% Club.

In 2013 TCAM may escalate to a vote against where there is still no progress or indication of positive momentum.'

NEST expects that in the coming years many more of the institutional asset owners that control billions of euros of EU corporations will take a similar approach to voting and engagement.