CORPORATE BOARD GOVERNANCE & THE DIVERSITY-PARTICIPATION PARADOX

- A NOTE ON THE BANKING SECTOR

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1. Introduction

In June, 2009, James Surowiecki, wrote in his regular New Yorker column "The Financial Page" of the failure of bank boards of trustees to stop "banks disastrous behavior." [Surowiecki, 2009, "Board Stiff, The New Yorker, June 1, 2009]. He cited decades of attention to improving bank boards by *adding outside and independent members and [thereby] making them more diverse with respect to age, gender, and background*. He went on to say that there is little evidence that these changes have made a difference in improving bank performance. [Surowiecki, 2009]. This notion leads to the paradox that we want diverse groups to represent more stake-holders in making decisions, but because the members are diverse, it reduces their ability to communicate with each other.

The purpose of this paper is to consider four related questions pertaining to Mr. Surowiecki's observation of bank boards. First, why should bank's trustee boards be diversified, and how should that make a difference in bank performance? Second, at what cost are bank trustee boards diversified? Third, did bank trustee board diversification actually happen, and what are the outcomes to which we can point?

1.1. Why diversify a bank's trustee board and how should diversification be expected to improve the bank's performance?

Corporate boards are expected to be central to strategic decision-making. This statement is generally thought to be true of most corporations but it is certainly expected to be true of banks, whose stakeholders expect a high level of fiduciary responsibility from the boards, as well as their audit, and compensation committees. Since Sarbanes-Oxley, banks are thought to have moved toward boards with more diverse memberships, which means including women, minorities, younger, and outside members who may not have banking backgrounds. It is reasonable to expect that board and committee members are selected for their own unique personal qualifications and the contributions they portend. Their particular contribution may be based on a skill, knowledge base, or functional viewpoint, or may be to represent a particular business-type or demographic perspective. Ideally, board members are selected because those contributions are expected to enhance the quality of the bank's decisions and outcomes.

There are many arguments for board member variety. The literature in management, sociology, social psychology, and organization theory include hundreds of recent scholarship supporting diversity in decision-making. However, most importantly in the banking industry it is now a legal requirement. Harvard University legal scholar Cass Sunstein argues that homogenous groups of like-minded people, including investors and executives, tend to adopt narrower and more extreme positions than groups with a diversity of opinions. He suggests that group polarization was in part responsible for the American financial crisis of 2008 [Cass Sunstein, "Going to Extremes, How Like Minds Unite and Divide," Oxford University Press, 2009 p. 2]. Scott Page, in his book "Difference," argues that in almost all cases diverse groups make better decisions than homogeneous groups stating that in decision-making, "diversity trumps expertise." The difference we expect to see is board decisions that are based on broader inputs, more mission-based in terms of the vision and strategy of the bank, and more representative of all the stakeholders of the bank

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1.2. What are the costs of diversifying bank trustee boards?

The first cost can be the fruit of the diversity itself. As important as increasing board diversity is, there is a catch; the more diverse a board becomes, the more difficult board communications become. That is, as *member differences increase; successful communications between those members becomes more difficult*. Diversity leads to changes in a board's group dynamics and that, in challenges the involvement, engagement, and the individual contributions of those board members who were brought for the express purpose of being heard. In other words, *as a bank board's level of diversity increases, its ability to harvest the expected advantages of that diversity may actually decrease*.

Another cost may well be the learning curve of the new, and less experienced members. They may need training and mentoring to learn the board and bank processes. Also, there is potential for board divisions between the traditional members and the more diverse members. This may be based on diminished trust and respect, or it might be based on different decision choices, some riskier and some more risk aversive. The traditional team may have greater loyalty to the bank executives and the more diverse members may look to outside project proposals. These costs are difficult to quantify, but further research should look to this important question.

1.3. Has bank trustee board diversification actually happen?

This first stage research considered seven international banks (Headquartered in England, Ireland, Japan, Scotland, Spain, and the United States of America) on the basis of their board and committee diversity and on specific outcomes of member participation and bank success measures. The first purpose was to determine the level of diversity among the Boards of Trustees in their current configurations and to do a longitudinal check over a five-year time span to see the extent to which the board's levels of diversification had changed. The results of this analysis are discussed below, and refer to Tables A1, A2, and A3 at the end of the paper.

The second purpose was to look at various outcome measures to see if there is any sign of improvements over the five year time span. At this point, the second purpose is made difficult due to the major changes in the world-wide banking system during that period. Outcomes concerning bank performance were significantly affected, and as the results are based on simple observations, they do not, at this point, merit speculation other than to suggest that the second stage investigation will rely on sophisticated methodology including analysis of variance methodology and will look at more sophisticated data. First, the following are brief definition s of the pertinent terms.

Definition of diversity: Diversity refers here to the mix of board and committee membership consisting of the board's population statistics and the relative numbers of women, younger members, long-term members, bank employee members, and those members with non-banking backgrounds.

Definition of Participation Rates: In this, the initial stage of the study, participation rates focus on the extent to which the diverse members sit on important committees, such as the auditing, compensation, and risk analysis committees. The ongoing assumption is that all board members are chosen for a rational reason; that is they are there for a purpose, which is to improve the quality of the decisions and actions of the board.

The Diversity-Participation-Paradox: All too often committee speed and efficiency becomes the enemy of effective full participation by boards or committees. Decisions and actions taken by bank trustee boards and their various sub-committees are not the same as those of the everyday actions and decisions made by organizations. Bank Boards of Trustees are different in that they have immense and expansive financial responsibility to their stakeholders and they make their decisions under extensive scrutiny. It is widely believed that they are held accountable for the outcomes of their very complex decisions. The potential liabilities and consequences of one-sided executive, personnel, risk, or audit committees, and their decisions suggest that special leadership ability and interventions may be called for. Shareholders want to know that due diligence was performed in major decisions. Bank of America shareholders must have wondered what the board was thinking when it allowed Kenneth Lewis's sudden agreement to the acquisitions both Country-Wide Financial and the struggling Merrill Lynch. However, the bank president's personal level of commitment to that decision was of a higher level and more consequential than that of the board.

The actual changes: Between 2003 and 2008, five of the seven banks reduced their board sizes (Bank of America by 3, Barclays by 2, Royal Bank of Scotland by 5, Santander by 2, and J. P. Morgan Chase by 1), and two increased their board sizes (Mitsubishi by 5 and National Irish by 4). In the case of four of the five that reduced their board size, they also reduced their number of female members, three reduced the number of board members under 50, and four reduced their members with non-banking background. One bank, Mitsubishi, did not change the number or percentage of female board members, going from zero to zero. One bank, National Irish, increase female representation by over 24%, going from one to five women members. In summary, looking at all studied measures of diversity (women members, members under 50 years of age, and non-banking members) during the five years from 2003 to 2008, there was a net loss of diversity in all categories. Racial minorities were not considered due to the difficulty in defining racial identities and the difference in definition of racial minority status in the different corporate headquarter county of origin.

It is not difficult to speculate on the overall reduction of a diversifying trend in the big banks considered in this note. Change is difficult, and in the later part of the five year span, banks were facing challenging times, and a more conventional bank board possibly provided appearance of competence and conservative outlook. None-the-less, there was a reduction in young, female, and non-banking members. The overall reduction in board size, coupled with the reduction in board diversity, is one way to reduce the challenge of board leadership.

Between 2003 and 2008 the banking industry underwent dramatic challenges and changes, and it would be tempting to make suggestions of a causal relationship or lack of a relationship having to do with the diversity of the board membership. However, even in light of the comments by earlier mentioned authors, the banking crisis was driven by much larger economic and regulatory factors and cannot be attributed to the board participation paradox. However, the following is a review of selected relevant research in this area.

2. Recent Research on the Paradox of Diversity and Participation on Boards

Most recently, a study published in the Academy of Management Journal reported on the effect of diversity on teams and ultimately of their performance. In their paper, the authors cited increasing "reliance on teams to generate solutions for sustained business success…" and "…a surge in research on how teams should be composed to foster high performance" [Kearney, Gelbert and Voelpel, 2009, p 581]. Part of that surge on is represented by Scott Page's 2007 article suggesting that diverse boards often out-perform homogeneous boards because of what he called super-additivity of what diverse members bring to the table. In other words, diverse boards are important and corporations spend billions of dollars in training and recruiting high talent and diverse members. [Making the Difference: Applying Logic of Diversity, By Scott E. Page, the Academy of Management, Perspectives, V 21, Num. 4, November 2007, Page 6]. Many aspects of this paradox have been studied in relationship to decision-making and problem-solving teams. One such study looked at the role of boards where member's backgrounds differed on, among other things, their industry and occupational histories. They found that these factors were significant in affecting board communications effectiveness. [The Role of Context in Work Team Diversity Research: A Meta-Analytic Review. By Aparna Joshi, Hyuntak Roh, the Academy of Management Journal, V. 52, Num. 3, June 2009 Page 599]

Another consideration in the paradox is the effect of "open-mindedness" of member's personal traits as it might affect the dynamics a diverse group and its outcomes: They studied diverse four-person teams engaged in interactive tasks, to determine whether their performance was influenced by the "openness to experience" of the members and found that the "openness" variable had an important positive effect on most diverse teams. [Facing Differences with an Open Mind: Openness to Experience, Salience of Intra-group Differences, and Performance of Diverse Work Groups, By Astrid C. Homan, John R. Hollenbeck, Stephen E. Humphrey, Daan van Knippenberg, Daniel R. Iigen, and Gerben A. Van Kleef, The Academy of Management Journal, V. 51, Num 6, December 2008, Page 1204]. "Empowering Leadership" and its effects on the outcomes of diverse management teams in over 100 U.S. hotels was studied to understand the roles of knowledge sharing and team efficacy as it might intervene in the relationship between "empowering leadership" and team performance. Team performance was based market outcomes. The authors stated that that empowering leadership was positively related to knowledge sharing, which was positively related to performance. [Empowering Leadership In Management Teams: Effects On Knowledge Sharing, Efficacy, And Performance, By Abhishek Srivastava, West Virginia University, Kathryn M. Bartol and Edwin A. Locke, University of Maryland, Academy of Management Journal, V. 49, Num 6, Page 1239]. An eye-opening insight came from the outcome of a study which considered "expertness," as it relates to the need and availability of "helping behavior" in diverse boards. This research investigated the germane issue of members helping other members. Looking at these boards, the researchers observed that *in highly diversified boards members will be more committed to and more likely to help those seen as more expert and seemingly less in need of help, than those seen as less expert and most in need of help.* [Expertness Diversity And Interpersonal Helping In Teams: Why Those Who Need The Most Help End Up Getting The Least, By Gerben S. Van Der Vegt, J. Stuart Bunderson, Aad Oosterhof, The Academy of Management Journal, V. 49, Num. 5 October 2006, Page 877]. The insight is that less expert members may become increasingly isolated in their board experience.

In an earlier study [Bjorklund, page 154] of financial decision-making boards where expertness and preparedness was considered, leadership style showed up as the important factor in solving the diversity-participation paradox. When the leader took a *participative approach*, giving initial directions but letting the group members decide on order and agreement on results, the boards were very efficient at deciding but the diverse members were basically shut out of the process. Surprisingly, the *autocratically led boards* created more opportunities for input for the diverse members. During the meetings, more and different people spoke for shorter amounts of time. The autocratic leader, who was committed to participation by all members, called members out for input and therefore was best at satisfying the "full participation" outcome.

Two general conclusions emerged from this research. First, there are many reasons why some members don't participate in boards, and second, there is a need for advanced leadership skills to overcome any of those the difficulties in any board or committee. Leadership and leadership techniques are important processes in decision-making boards where diverse member input is a desired outcome.

For the purposes of this paper, leadership is defined as an interactive process between the group's convener and its participants where the leader focuses on influencing all of the diverse individuals in the group to achieve a common goal through demonstrating specific behaviors. This is a leader-centered perspective on the process of influence, where the leader is defined through his or her behaviors – more specifically, relationship behaviors, which are aimed at helping subordinates feel comfortable with themselves, with each other, and with the situation in which they find themselves.

The approach to overcome the diversity/participation paradox is deceptively simple. The reasons for differences in member participation rates are many. A few examples are listed below:

1. Age, where a significantly older or younger member may be uncomfortable.
2. Gender, where a member of a board is the only woman or man, and feels marginalized.

3. Race, where a member of an under-represented race feels a lack of respect from or toward the group.
4. An "outside" member of any board who is expected to play an important role.
5. A member whose educational level or type is different from most members
6. A very introverted person
7. A person new to the organization or with less experience
8. Emotional Intelligence
9. Personal Wealth

These are a few categories where significant diversity-participation challenges commonly occur. Some board members feel out of place, unable, or unwilling to share important data that would influence the outcome of the board. We have all experienced the feeling of being the odd member, and we have all experienced being in a group where someone else did not participate.

3. Conclusions

There are a vast number of combinations and permutation of possible communications issues arising from diversity on boards. However, the point is that there is no need for a different approach to solving each different type of board diversity/participation setting. There is one *necessary and sufficient* factor that can overcome all of these challenges resulting from the diversity-participation-paradox. That factor is patient and focused leadership. We need leaders who are focused listeners and who encourage all board members to participate. The quiet member, who has been put onto a board for an important reason, should not be allowed to languish. The leader must demand contributions from each and every member. The leader can literally count the contributions, and when someone is hiding out, their opinion must be gently sought out.

Patience is called for from the board as well as the leader. If there are important issues, the group must be prepared to tolerate more, longer, and potentially less efficient meetings. It sometimes takes more time and patience to draw out all members, and to listen faithfully to contributions that may at first seem inappropriate. Those contributions should be heard and examined, and perhaps enhanced, extended, and expanded until they have reached their fullness. Group members will learn to speak their minds.

4. Recommendations

We recommend both special board and chair training, or a board consultant who will listen and provide direction, as it is needed. An independent board analyst can quietly provide process information for the chair that will be useful in hearing, understanding, and accepting input from all members as well as providing interaction analysis live during the actual meeting. Not all input is necessarily relevant or valid, and that is up to the board to determine, but when a member has been selected for a reason, that member should be heard.

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Appendix

TABLE A1. BANK BOARD MEMBERSHIP DATA FOR 2003

2003	# OF BOARD MEMBERS	# WOMEN ON BOARD	% WOMEN ON BOARD	# WOMEN ON SPECIAL CTEES	% OF WOMEN ON SPECIAL CTES	# UNDER 50	% OF UNDER 50	# WITH NON BANKING BACKGROUND	% OF NON-BANKING BACKGROUND
	#	#	%	#	%	#	%	#	%
BANK OF AMERICA	17	4	23.5%	0	0.0%	1	6%	15	88.2%
BARCLAYS	17	2	11.8%	2	11.8%	6	35.3%	10	58.8%
ROYAL BANK OF SCOTLAND	17	1	5.9%	1	5.9%	3	17.6%	12	70.6%
SANTANDER	21	1	4.8%	0	0.0%	1	4.8%	16	76.2%
MITSUBISHI	12	0	0.0%	0	0.0%	0	0.0%	2	16.7%
NATIONAL IRISH BANK	11	1	9.1%	1	9.1%	0	0.0%	3	27.3%
JP CHASE MORGAN	12	4	33%	0	0.0%	0	0.0%	2	16.7%

TABLE A2 BANK BOARD MEMBERSHIP DATA FOR 2008

2008	# OF BOARD MEMBERS	# WOMEN ON BOARD	% OF WOMEN ON BOARD	# WOMEN ON SPECIAL COMMITTEES	% OF WOMEN ON SPECIAL COMMITTEES	# UNDER 50	% OF UNDER 50	# WITH NON BANKING BACKGROUND	% OF NON-BANKING BACKGROUND
	#	#	%	#	%	#	%	#	%
BANK OF AMERICA	14	2	14.3%	0	0%	0	0	8	57.1%
BARCLAYS	15	0	0.0%	0	0%	2	13.3%	7	46.7%
ROYAL BANK OF SCOTLAND	12	0	0.0%	0	0%	1	8.3%	1	8.3%
SANTANDER	19	2	10.5%	1	5.3%	2	10.5%	6	31.6%
MITSUBISHI	17	0	0.0%	0	0%	0	0.0%	5	29.4%
NATIONAL IRISH BANK	15	5	33.3%	2	13%	3	20.0%	12	80.0%
JP CHASE MORGAN	11	2	18.2%	2	18.2%	0	0.0%	4	36.4%

TABLE A3 BANK BOARD MEMBERSHIP CHANGES FROM 2003 TO 2008

CHANGES 2003-2008	# OF BOARD MEMBERS	# WOMEN ON BOARD	% OF WOMEN ON BOARD	# WOMEN ON SPECIAL COMMITTEES	% OF WOMEN ON SPECIAL COMMITTEES	# UNDER 50	% OF UNDER 50	# WITH NON BANKING BACKGROUND	% OF NON-BANKING BACKGROUND
	#	#	%	#	%	#	%	#	%
BANK OF AMERICA	-3	-2	-9.2%	0	0.00	-1	-0.06	-7	-0.31
BARCLAYS	-2	-2	-11.8%	-2	0.12	-4	-0.22	-3	-0.12
ROYAL BANK OF SCOTLAND	-5	-1	-5.9%	-1	-0.06	-2	-0.09	-11	-0.62
SANTANDER	-2	1	5.8%	1	0.05	1	0.06	-10	-0.45
MITSUBISHI	5	0	0.0%	0	0.00	0	0.00	3	0.13
NATIONAL IRISH BANK	4	4	24.2%	1	0.04	3	0.20	9	0.53
JP CHASE MORGAN	-1	-2	-15.2%	2	0.18	0	0.00	2	0.20

TABLE B. SELECTED BANK PERFORMANCE CHANGES FROM 2003 TO 2008

BANK	SELECTED 2008-2003 FINANCIAL DATA (000)				CHANGE FROM 2003 TO 2008 IN PROFITS AS A % OF…		
	NET PROFIT	TOTAL REVENUE	TOTAL EQUITY	TOTAL ASSETS	REVENUES	ASSETS	EQUITY
BANK OF AMERICA	$ (4,534,000)	$ 83,058,000	$ 182,240,000	$ 1,459,167,000	-23%	-1%	-19%
BARCLAYS	£ 2,925,000.00	£ 10,688,000	£ 42,005,000	£ 935,568,000	-2%	0%	-12%
ROYAL BANK OF SCOTLAND	$ (6,210,320)	$ 50,861,000	$ 45,393,000	$ 1,208,486,000	-27%	-1%	-12%
SANTANDER	$ 3,799,200	$ 15,082,190	$ 12,658,700	$ 75,873,900	3%	-2%	4%
MITSUBISHI	$ 16,528,000	$ 14,307,000	$ 41,261,000	$ 1,134,003,000	83%	1%	32%
NATIONAL IRISH BANK	$ (2,234,000)	$ 51,945,000	$ 73,448,000	$ 2,701,006,000	-21%	-1%	-13%
JP CHASE MORGAN	$ 5,009,000	$ 67,178,000	$ 119,211,000	$ 1,261,077,000	-9%	0%	-7%