



مركز الحوكمة
CENTER FOR GOVERNANCE

BOARD COMPOSITION AND DIVERSITY

How to Build a Balanced and Effective Board of Directors



A PIF COMPANY

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Center for Governance

Report

TABLE OF CONTENTS

| | |
|--|----|
| 1. INTRODUCTION | 05 |
| 2. COMPOSITION AND DIVERSITY AS DRIVERS OF BOARD EFFECTIVENESS | 05 |
| 3. THE “RIGHT” BOARD COMPOSITION AND DIVERSITY | 07 |
| 3.1 ALIGN AND CALIBRATE BOARD COMPOSITION TO STRATEGY. | 07 |
| 3.2 BUILD A ROOM WITH (MANY) VIEWS | 07 |
| 3.3 STAY ACTIVE | 08 |
| 3.4 CLARIFY WHAT YOU NEED | 09 |
| 3.5 CLARIFY WHAT YOU HAVE | 09 |
| 3.6 CLARIFY HOW TO DO IT | 09 |
| 3.7 AND NOW WHAT? | 10 |
| 4. LOOKING AHEAD | 11 |
| 5. ABOUT US | 12 |



INTRODUCTION

Who is on the board matters immensely? The effectiveness and quality of a board's performance begins and ends with the individuals seated at the table. In corporate governance, there is a persistent myth that a board's structure inherently reflects its quality. Instead, board quality is most strongly influenced by its composition and diversity specifically, who sits on the board and how diverse directors are in terms of perspectives, skills, and experiences. Board composition and diversity are important because they can significantly affect board quality or how effectively the board carries out its responsibilities. Despite this, board composition and diversity remain under-researched. The key to achieving high-quality board performance lies in understanding and prioritizing composition and diversity to foster a board capable of driving meaningful governance and impact.

COMPOSITION AND DIVERSITY AS DRIVERS OF BOARD EFFECTIVENESS

Assessing board quality solely by examining its structure such as the number of independent directors has significant limitations. This has led to growing demand for deeper insights into what truly drives board effectiveness or "quality" (i.e., how well a board fulfills its responsibilities).

Notably, major corporate governance crises have occurred even in companies that appeared to have the appropriate structural features, such as General Electric, Credit Suisse, and Wells Fargo. This suggests that to understand the drivers of board effectiveness, we need to look beyond structure. Since boards share many characteristics with other types of teams, their effectiveness is likely influenced by two key factors: who sits at the table (composition) and how diverse the board is¹. These elements profoundly impact how the board operates and ultimately determines its effectiveness.

While board composition refers to the skills and expertise that board members bring to the table, diversity reflects the range of backgrounds, skills, experiences, and genders represented on the board. Board composition and diversity are closely interconnected, like two sides of the same coin. The ideal board composition and diversity require thoughtful and intentional effort from the board. This includes driving adjustments in composition and diversity through board evaluations and succession planning, ensuring alignment and continuous calibration with the evolving needs of the business.



¹ Cheng et al. (2021). Directors' Perceptions of Board Effectiveness and Internal Operations. *Management Science*, 67(10), available at: <https://pubsonline.informs.org>

This is a governance area where demands for greater transparency remain high, as composition and diversity are crucial to how directors fulfill their responsibilities and enhance board effectiveness.

Investors are increasingly focusing on board composition and diversity to enhance board effectiveness and drive shareholder value. They aim to understand the unique blend of personalities, perspectives, experiences and skills on the board, how these attributes evolve over time, and how the board fulfills its responsibilities. Shareholders increasingly expect boards to demonstrate why existing directors are well-suited to address the business strategic priorities. They also question the processes in place to adapt and refine board composition and diversity as business needs evolve. Saudi Arabia's Public Investment Fund adopts a foresighted approach that sees strong governance, board composition, and diversity as key factors for the success of its portfolio companies². Other key, large investors, including Vanguard, BlackRock and State Street, have promised to vote against directors who fail to show or promote board diversity (the "Big Three's Campaigns")³.

Beyond investors, board composition and diversity are also on the radar of stakeholders, including proxy advisors and regulators who view them as important drivers of risk oversight and promoting long-term value. Saudi Arabia's Capital Market Authority requires several aspects of diversity for membership of a public board (including ability to lead, to guide and competency),⁴ while other countries (including Germany, France, the US and the UK) have legal requirements in place for board diversity in listed companies.⁵

With all this scrutiny, how can boards get composition and diversity "right"?



² Public Investment Fund (2024). How PIF is Embracing Diversity in the Boardroom to Deliver Long-Term Impact, available at: <https://www.pif.gov.sa>

³ Deloitte (2019). Women in the Boardroom, 6th Edition, available at: <https://www2.deloitte.com>

⁴ CMA (2023). Corporate Governance Regulations, available at: <https://cma.org.sa> Clifford Chance (2023.) Global Board

⁵ Diversity Tracker. Developing a Global Approach, available at: <https://www.cliffordchance.com>

THE “RIGHT” BOARD COMPOSITION AND DIVERSITY

One of the most destructive myths of governance is the belief that best practices exist and adhering to them will instantly lead to better performance and oversight. Despite numerous studies⁶ and significant regulatory attention, we have not yet uncovered standards that consistently correlate with improved board effectiveness and governance. What are often labelled as best practices risks being reduced to box- checking exercises, oversimplifying the complexity of companies and their governance.

In this context, the “right” mix does not exist. What we do know is that focusing on board effectiveness leads us to prioritizing board composition and diversity as elements that significantly influence engagement and the board’s ability to carry out its duties effectively (board quality). Thus, the following actions emerge as critical:

3.1 Align and calibrate board composition to strategy

As the business environment evolves, strategic priorities can shift—and so should board composition. The board’s capacity to oversee and guide strategy depends on how knowledgeable directors are about current topics and trends. In this context, a broader view of board composition and diversity is essential. Directors must be equipped to scan the environment and understand the layers and shifts of the competitive landscape, anticipate potential disruptions to the business model, and navigate the complexities of technological advancements relevant to the company’s strategy.⁷

3.2 Build a room with (many) views

Boards should have a broad view of diversity, including characteristics beyond gender, such as skills and different perspectives. Cognitive diversity refers to how directors and the board as a whole think, process information, and approach problem-solving, while non-cognitive diversity includes other characteristics such as perseverance, conscientiousness, and teamwork. Building a room with diverse views has become increasingly relevant as greater importance is placed on technology, ESG, regulation and the future of work. By prioritizing cognitive and non-cognitive diversity, boards can shield themselves against the threats of blind spots. Increasingly, diversity also encompasses age. In 2022 the average age of directors on Saudi Arabia’s listed boards was 50, significantly younger than their counterparts in Switzerland or France (60), Singapore (62), the US (63) or Japan (64)⁸. Multigenerational boards can offer much needed, fresh perspectives. Becoming a director often requires significant executive experience and influence, as effective oversight and guidance are typically built on years of expertise. However, multigenerational boards can help align the board with today’s workforce, consumer base, and the technological revolution brought by Industry 4.0, a fusion of physical, digital, and biological innovations. Creating a boardroom with many views can also improve board performance at sensing, understanding, and navigating market dynamics and new business models. This is particularly effective when the Chair is able to build consensus in a timely manner and avoid deadlock on topics such as sustainability, AI and cybersecurity. Younger and/or more diverse directors are increasingly holding the (board) fort, either as independent directors or as experts.

⁶ Affes & Jarboui (2023) The impact of CG on financial performance: a cross-sector study; Drobetz et al (2003) Corporate Governance and Firm Performance: Evidence from Germany; Yusuf et al (2023) Integrated reporting, CG and financial sustainability in Islamic Banking; Bhatia & Kumari (2024) The moderating effect of corporate governance factors on capital structure and performance: evidence from Indian companies.

⁷ Harvard Law Scholl Forum on Corporate Governance (2024). How Can Boards of Directors Improve Their Effectiveness? Available at: <https://corpgov.law.harvard.edu>

⁸ Heidrick & Struggles (2023). Board Monitor Saudi Arabia 2022, available at: <https://www.heidrick.com>; SpencerStuart (2023). Boards Around the World, available at: <https://www.spencerstuart.com>.

3.3 Stay Active

Calibrating the right board composition and diversity requires the board to take an active and holistic approach—one where these factors are not standalone but integrated with intentional board evaluations and succession planning. Typically, changes in board composition occur as people leave or retire. A robust, proactive succession planning process should be in place to identify the “right” director to fill an open seat. Too often, replacing a board member is done in an ad hoc manner or as a standalone task, without a thoughtful and comprehensive review of what the board truly needs. Only 42% of directors report having a formal, documented, and regularly reviewed board succession plan in place to ensure continued alignment⁹. With 92% of executives indicating that one or more directors on their board should be replaced and only 19% considering their boards sufficiently diverse, staying active offers serious food for thought.¹⁰

A useful action plan to stay active could include:



⁹ Nasdaq (2023). Global Governance Pulse, available at: <https://nd.nasdaq.com>

¹⁰ PwC (2024). Board Effectiveness: A Survey of the C-Suite, available at: <https://www.pwc.com>

3.4 Clarify what you need

Board evaluations are critical to identify the board needs, promoting high performance and set a strong tone at the top. A recent Harvard study highlights disparity between C-level executives and directors' views regarding board needs, namely the importance of specific areas of expertise¹¹. Directors prioritize traditional areas such as accounting, finance, and risk management, while executives emphasize the need for industry, sustainability, and regulatory or public policy expertise. This indicates that boards can expect pressure from the C-suite to incorporate more qualitative diversity.

There is, however, alignment between directors and executives on the importance of expertise in innovation and technology, cybersecurity and data privacy, human capital and talent management, and executive leadership experience¹². Robust board evaluations and formal board succession planning are essential to help boards achieve the “right” composition and diversity.

3.5 Clarify what you have

Board composition and diversity require some form of evaluation to establish the status quo at any point in time. While 73% of directors believe that proper board evaluations are effective in promoting board refreshment¹³ governance has a long history of evaluations being conducted as window dressing or “box-checking” exercises. Many assessment processes lack objectivity, rigor, and the frankness that an independent third party can bring to the table. In 2024, 46% of directors still believe that “box-checking” exercises remain a problem.¹⁴

This issue can often be attributed to a lack of shared understanding about the purpose of board evaluations. Boards need to agree on what they aim to achieve with these assessments as, ultimately, board evaluations are a critical tool to maintain the appropriate board composition and diversity, enhance board quality and promote accountability, board education, and a culture of governance excellence.

3.6 Clarify how to do it

When it comes to evaluating board composition and diversity, it is common practice for boards to self-evaluate using questionnaires, group discussions, and/or individual interviews with directors. While 88% of directors have full trust in their board’s ability to self-assess, the top reasons cited for not replacing underperforming directors include personal relationships, collegiality, a tendency to avoid difficult conversations, and the significant time and effort required for the replacement process.¹⁵

Increasingly, boards are turning to third parties to facilitate the evaluation process. A candid, neutral, external perspective can foster greater openness and honesty around the table, provided the facilitator(s) has significant experience in working with boards and managing the sensitivities of individual directors. Third-party facilitators often use surveys, lead discussions with the entire board, and conduct interviews with individual directors. Regardless of who conducts the evaluation, it is beneficial to include feedback from management on the board and its directors.

¹¹ Harvard Law School Forum on Corporate Governance (2024). Board Composition: Building your Dream team, available at: <https://corpgov.law.harvard.edu>

¹² Janahi et al. (2022). Age Diversity and the Monitoring Role of Corporate Boards: Evidence from Banks, available at: <https://journals.sagepub.com>

¹³ PwC (2019). Annual Corporate Director Survey, available at: <https://www.insurance.ca.gov>

¹⁴ wC (2024). Annual Corporate Director Survey, available at: <https://www.pwc.com>

¹⁵ PwC (2024). Board Effectiveness: A Survey of the C-Suite, available at: <https://www.pwc.com>

3.7 And now what?

Following a board evaluation, we would expect boards to have the right follow-up, typically an action plan addressing, among other things, the composition and diversity issues identified during the assessment. Unfortunately, this is not the case. Only 7% of directors report that evaluations result in specific action plans¹⁶, while 72% say that the board has taken some action but cannot identify who is responsible for the follow-up or whether any action plan was implemented to address the issues raised during the evaluation¹⁷. Board leadership is key to drive change, particularly following a board evaluation. 85% of directors believe that the Chair or Vice-Chair must drive board refreshment actions when the findings support it, ensuring the board achieves the “right” mix of composition and diversity.¹⁸

Whatever action follows board evaluations, two things are clear. First, elevating board quality through calibrating composition and diversity requires an intentional and ongoing process. Interventions throughout the year should complement evaluations. Second, to encourage directors buy-in for “evaluation,” it is helpful to move away from this term, as it is often perceived negatively and can create discomfort, even for senior professionals. Instead, positioning these efforts as tools to calibrate board composition and diversity, among other factors, can emphasize their role in enhancing board quality and continuous improvement, shifting the focus toward the ultimate goals of these activities.



¹⁶ Nasdaq (2023). Global Governance Pulse, available at: <https://nd.nasdaq.com>

¹⁷ Harvard Law School Forum on Corporate Governance (2022). Conducting Effective Board Assessments, available at: <https://corpgov.law.harvard.edu>

¹⁸ SpencerStuart (2021). Getting Real value from Board Assessments, available at: <https://www.spencerstuart.com>

LOOKING AHEAD

Board composition and diversity play an important role in shaping board quality and how effectively the board carries out its responsibilities. Shareholders, stakeholders and regulators are placing increasing pressure on boards to establish and maintain the “right” board composition and diversity to drive board quality and, ultimately, shareholder value. Many boards are rethinking their approach to composition and diversity from start to finish: from finding, recruiting, and onboarding directors to implementing board evaluations and succession planning as key tools to align board composition and diversity with evolving business needs. Among the skills and backgrounds boards seek for the future, digital skills are at the top of the list, followed by ESG skills, future planning skills, listening skills, emotional intelligence and strong corporate governance skills.¹⁹

Getting the appropriate board composition and diversity is not straightforward and requires an ongoing, intentional approach by the board. There are tools available to make the process less guesswork and more systematic. To build a well-rounded, diverse board that can drive board quality, it is essential to proactively manage board evaluations and succession. Once priorities are set or shifted, boards can work backward to map out the board composition and diversity needed to govern those priorities effectively. Ultimately, corporate governance encompasses oversight, advisory, and decision making, all board responsibilities that require the “right” mix of board composition and diversity to drive quality in board performance.



¹⁹ Corporate Governance Institute (2024). Boardroom Skills – do you have what it takes to join a board? Available at: www.thecorporategovernanceinstitute.com



ABOUT THE CENTER FOR GOVERNANCE

The Center for Governance was established by the Public Investment Fund (PIF) in 2020, and is dedicated to enhancing corporate governance capabilities and know-how in Saudi Arabia and beyond. We are a catalyst for governance excellence in the Kingdom, delivering practical solutions that elevate standards, build trust and foster societal progress.

sectors in three core areas:

- We undertake board evaluations for all kinds of entities, and provide advisory services relating to governance, risk and compliance.
- We design and deliver development programs aimed at board members, the C-Suite and governance professionals.
- Through rigorous research and thought leadership, we uncover new insights that raise awareness and understanding of governance, directorship and organizational performance.

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