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THE REGULATORY CASE FOR A MORE INCLUSIVE AND DIVERSE INDUSTRY

May 2022

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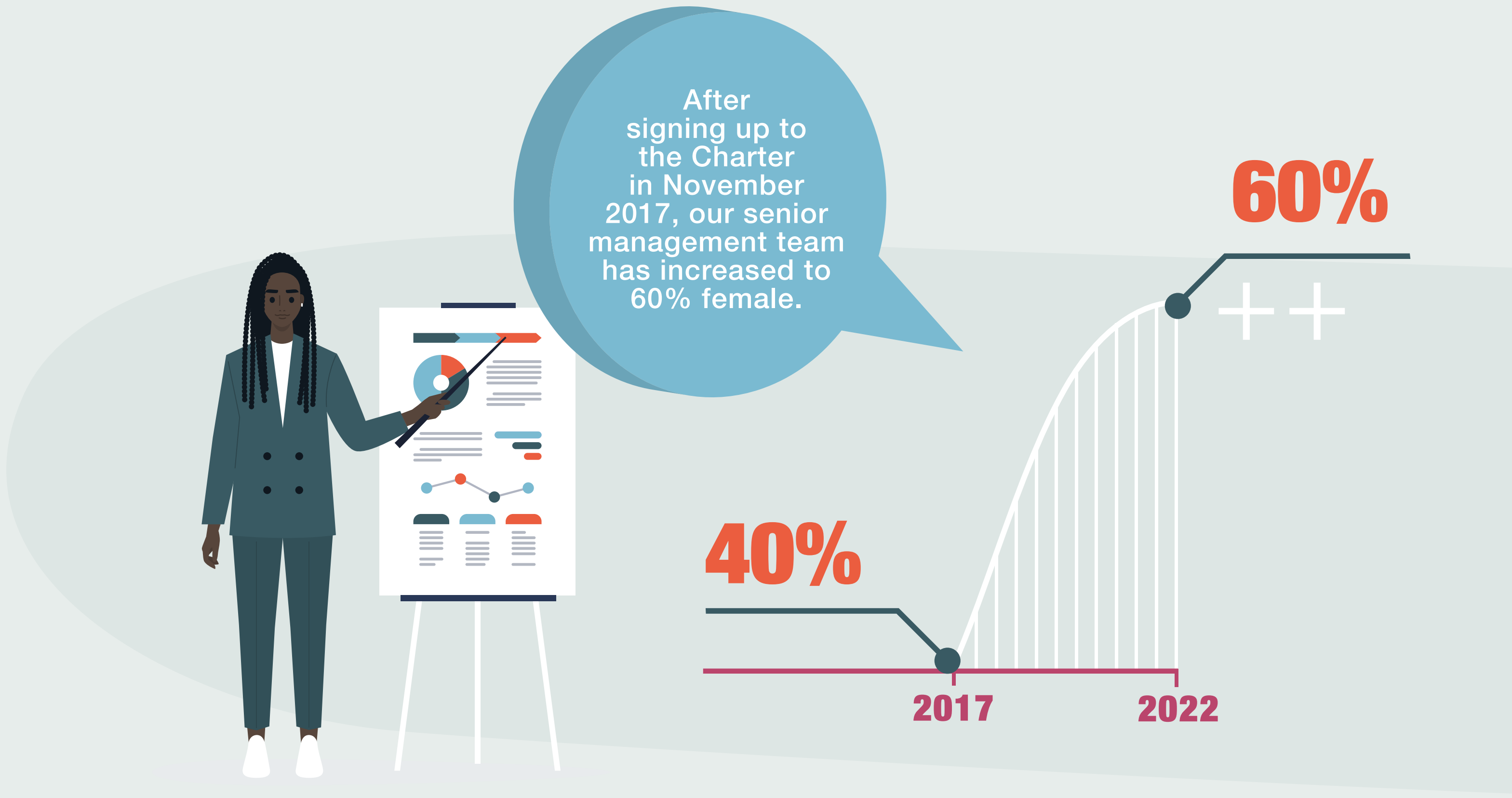
FOREWORD

Building a more inclusive society and economy is now a major priority. UK equalities legislation has been evolving for over half a century with key milestones including the Equalities Act in 2010 which identifies a wide range of 'protected' groups based on characteristics such as gender, race, sexual orientation, religion, and disability. Against this backdrop, the need to improve 'Diversity & Inclusion' (D&I) has become a key metric for all business leaders in measuring the performance of their business.

For personal investment services and advice firms, measuring progress on D&I goes well beyond the composition of their own board or workforce. Firms need to think about the diversity of their supply chains and distributors. They must think about the impacts of their activities on a diverse customer base. Senior managers must also respond to the changing expectations being set by regulators for whom diversity is increasingly seen as a key issue in helping to reduce business risks and improving performance.

Whether senior leadership teams take D&I seriously can have significant impacts on all a businesses' stakeholders. There are many tools at the board's disposal including having a firm commitment by the senior leadership team which in turn helps to shape the firm's culture. This commitment needs to be aligned with internal and external communications, brand, marketing, and internal policies and processes, such as staff recruitment, retention, remuneration and procurement. Firms also need to factor in product design to ensure that all clients can freely access products and services in line with the existing equalities legislation.

THE LACK OF DIVERSITY IN CORPORATE BOARDROOMS REMAINS AN ISSUE THAT WE NEED TO FULLY ADDRESS.



IN 2021, ONLY 12 PERCENT OF THE SENIOR LEADERSHIP TEAMS OF THE FTSE 100'S FIRMS WERE FROM ETHIC MINORITY BACKGROUNDS[2]

While progress has been made, it remains slow. Gender representation also continues to be a big issue, particularly in executive and leadership roles. This, of course, highlights an important issue: **how do we define diversity?** Whilst personal characteristics – such as gender and race – are important, not all diversity characteristics are visible – such as disability or sexual orientation. Equally important are issues such as diversity of thought and experience, which are also far harder to measure and monitor.

D&I is an issue that PIMFA has identified in our Members Manifesto as a key area to address, and the recent 2022 strategy refresh with members confirmed it as a top priority for firms. PIMFA is a signatory of HM Treasury's Women in Finance Charter[3].

At an industry-wide level the charter has also led to significant improvements. Since its introduction in 2016, the proportion of females on the board at 200 of Britain's top financial firms has risen to 32% from 23%. But while great strides have been made, there is still a long way to go.

PIMFA has untaken a pilot with The Brokerage on the Social Mobility Challenge, an initiative which supports disadvantaged young people to achieve their career potential[4], the results of which are informing a broader industry strategy. As a champion for D&I in the personal investment services and financial advice profession, we aim to encourage and facilitate the conversation that will be essential for improvement across our industry. We continue to enable the financial services community to learn from each other's experiences, through both our annual D&I Awards and Wealth of Diversity Conference, both of which we hope push forward progress across the industry for firms large and small.

Our aim with this report is to provide you with a better understanding of how your approach to D&I is already an issue that the regulator is taking an active interest in and how that is likely to develop over the coming year. Ultimately, industry leaders need to play a key role in creating diverse and inclusive cultures. While the potential benefits of such a culture can be seen as the carrot through which to encourage progress, firms face an ever-increasing risk of the regulatory stick should they fail to do so.

[1] McKinsey, Diversity wins: How inclusion matters, May 2020
[2] Green Park, Business Leaders Index 2021: FTSE 100, August 2021
[3] PIMFA, Women in Finance Charter
[4] PIMFA, The Social Mobility Challenge

THE IMPORTANCE OF **DIVERSITY AND INCLUSION** IN FINANCIAL SERVICES

1 Ensuring an inclusive business culture

The discussion of D&I often focusses on diversity in isolation. However, without inclusion, diversity in its fullest sense cannot and will not be realised. Jonathan Davidson, former Executive Director of Supervision at the FCA, notes that:

> "Without safety, without inclusion, the value of diversity is lost, and that diversity will eventually wither and die."[5]

Greater diversity within an organisation provides the opportunity for different perspectives, and more informed decision making as a result. However, employees will not feel confident in communicating those diverse views that come from a different lived-experience without an inclusive business culture that empowers them. Diversity in isolation will not lead to improved approaches. As explored in the FCA and PRA's joint discussion paper, DP21/2:

> "An inclusive culture in which all staff can speak up allows the benefits of diversity to flourish. Together, diversity and inclusion can reduce groupthink, encourage debate and innovation, and thereby improve outcomes for consumers and across markets, supporting financial stability."[6]

It is the culture in the workplace that enables the diversity in a business to thrive and determines whether employees succeed and remain. Organisations that lack an inclusive environment are less likely to retain diverse staff. Research into the importance of company culture, conducted by Great Place to Work, found that employees that trust that they will be treated fairly, regardless of race, gender, sexual orientation or age, are over five times more likely to want to stay at the company for a long period of time.[7] Consequently, inclusion will determine whether an organisation's diversity is maintained in the long-term.

[5] FCA, The business of social purpose – speech by Jonathon Davidson, November 2020.
[6] FCA, DP21/2, Diversity and inclusion in the financial sector – working together to drive change, July 2021

[7] Great Place to Work, Why is Diversity & Inclusion in the Workplace Important?, April 2021

2 **Everything to gain:** A strong business case for diversity & inclusion

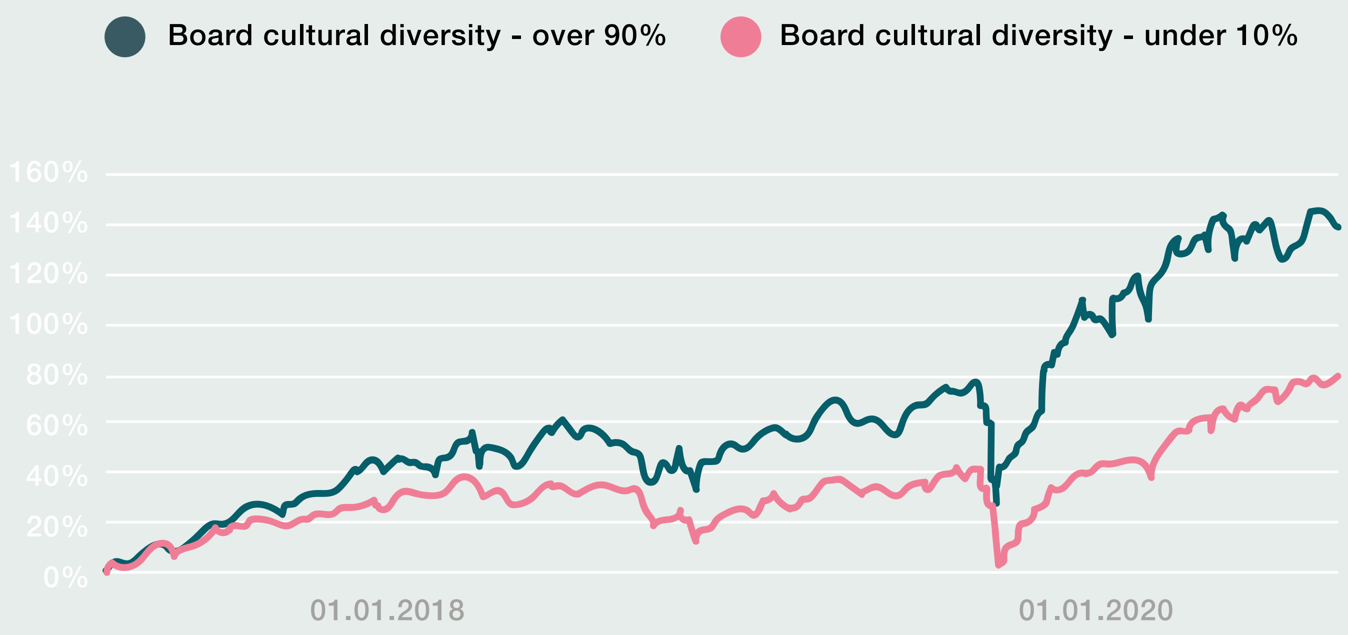
Firms that play a proactive role in furthering the D&I agenda within their organisation are, according to analysis from market data provider Refinitiv, more likely to outperform those that are less diverse.

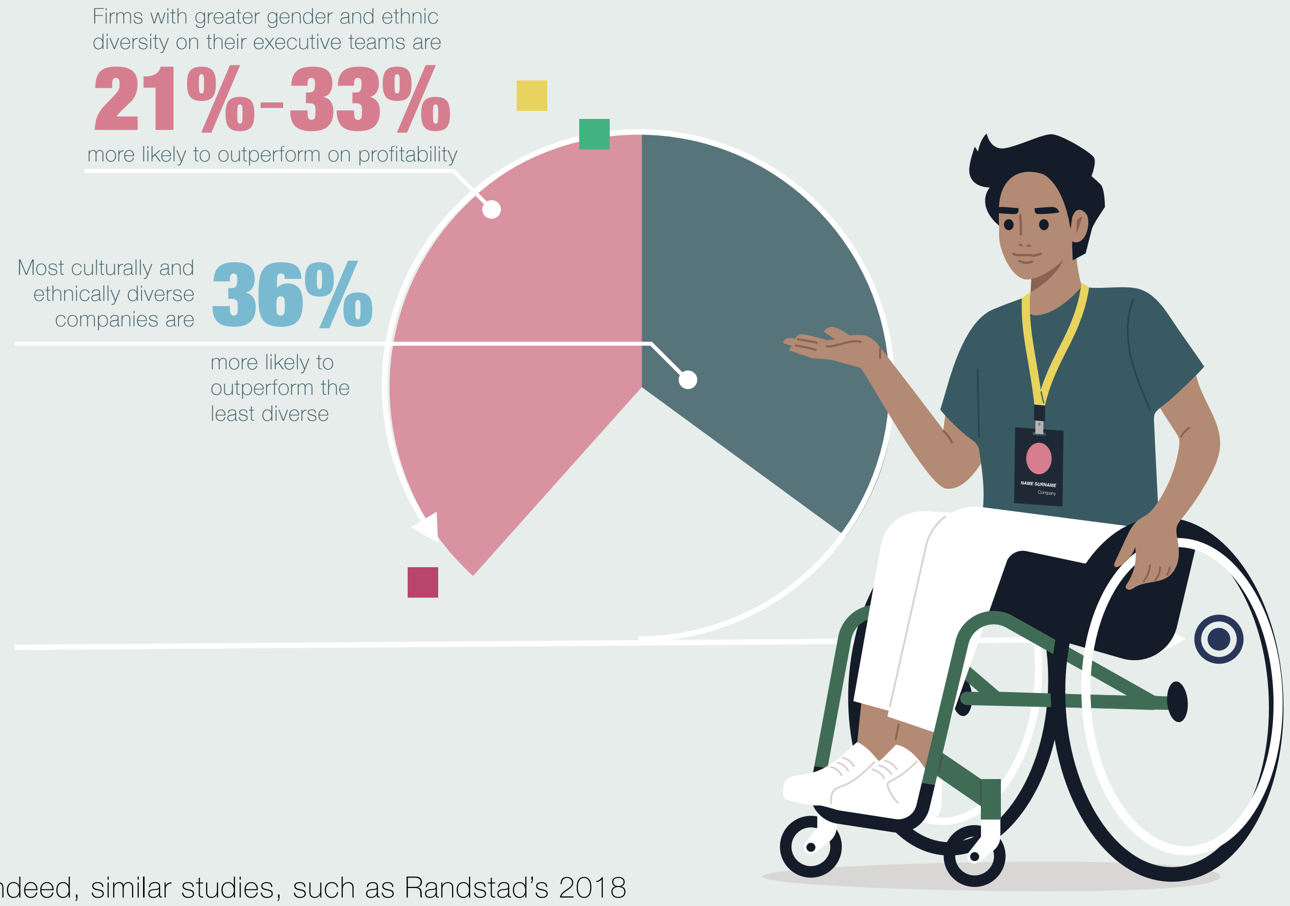
Refinitiv created two equally weighted portfolios, one with 90% board cultural diversity and the other with under 10% board cultural diversity, to analyse the impact of board cultural diversity on investment returns. Over five years, the portfolio with more board diversity significantly outperforms the other.[8]

FIGURE 1:

FIRMS WITH BOARD CULTURAL DIVERSITY ARE MORE LIKELY TO OUTPERFORM FIRMS THAT ARE LESS DIVERSE

PORTFOLIO TOTAL RETURN WITH BENCHMARK AS BASE (%)





Indeed, similar studies, such as Randstad's 2018 D&I report found that firms with greater gender and ethnic diversity on their executive teams are 21%-33% more likely to outperform on profitability than their counterparts.[9] Similarly, McKinsey's recent report, 'Diversity Wins', found that the most gender diverse companies are 25% more likely to outperform the least diverse, and that the most culturally and ethnically diverse companies are 36% more likely to outperform the least diverse. Since 2014, there has been a year-on-year widening of this performance gap. In short, the strong business case for gender, ethnic and cultural diversity in corporate leadership continues to strengthen.[10]

D&I, as well as positively impacting the profitability of a business, is tied to good conduct. According to FCA research, senior leadership teams with greater gender diversity have more positive risk management outcomes, good corporate governance, and conduct outcomes. Therefore, while diverse teams may have differences of opinion more frequently, these lead to more creative solutions which ultimately better serve the business itself, as well as the consumer.[11]

[8] Refinitiv, Refinitiv Insight: Diversity and Inclusion in the Post-Covid World, September 2021
[9] Randstad, Diversity and Inclusion within financial services, May 2018
[10] McKinsey, Diversity wins: How inclusion matters, May 2020
[11] FCA, Review of research literature that provides evidence of the impact of diversity and inclusion in the workplace, July 2021

3 **Diversity:**
Better serving client needs

The consumer duty, announced by the FCA in 2021, will require firms to ask themselves what outcomes consumers should be able to expect from their products and services, and then act to enable, rather than hinder, these outcomes. The D&I approach taken by firms can play a vital role in ensuring they meet the breadth of consumer need required. Georgina Philippou, Senior Adviser to the FCA on the Public Sector Equality Duty, highlights the role that a diverse workforce can play in facilitating the innovative thinking necessary to better serve the needs of all consumers.

> "People with different life experiences can bring new thinking and their experiences can inspire new approaches to problem solving and decision making. This can help firms to understand and meet the needs of all consumers, including those from diverse sections of society."

REGULATORY LANDSCAPE

1 Increased regulatory scrutiny

2021 saw UK regulators shift into gear in relation to D&I. The FCA, PRA and Bank of England promoted open discussion on the lack of diversity in the financial services sector, through a series of discussion, consultation and working papers, as well as action to mitigate against the exclusion of less represented groups. The regulators recognised their responsibility as employers, regulators, and public bodies to prioritise D&I within their operations and work.

The Bank of England set targets to increase its own gender and ethnic diversity. These included the target for 40-44% of senior managers to be female by 2028, and 18-20% of senior managers to be BAME. The FCA has been comparably ambitious in its targets, aiming for 50% female representation and 20% minority ethnic representation in their senior leadership team by 2025. The FCA emphasised that increasing its focus on D&I at firm level would also help to achieve its regulatory objectives to drive D&I within the financial services industry.

There was an overhaul in regulatory focus on D&I in 2021. The FCA prioritised improvements both to its own D&I, demonstrated by the appointment of Nikhil Rathi as CEO of the regulator, as well as in its wider policy discussion. In particular, the FCA and PRA published a joint Discussion Paper (DP21/2) calling for progress to improve D&I among firms via tools including leadership accountability and public disclosure,[13] ultimately supporting the FCA's mission to fulfil the needs of all consumers.[14]

An inclusive corporate culture encourages the retention of a diverse workforce within our industry, which in turn can enable firms to better serve a greater portion of the population, including the diverse groups that can sometimes find themselves unnecessarily excluded or disengaged from services we provide.

"I would question if any firm can adequately respond to the needs of these consumers if they do not have the diversity of background and experience required to overcome biases and blind spots. Ultimately, improving diversity and inclusion is both a matter of fairness and a crucial way to strengthen consumer outcomes."[15]

Nikhil Rathi,
March 2021

[12] FCA, Why does the FCA care about diversity and inclusion? Speech by Georgina Philippou, January 2021.
[13] FCA, DP21/2, Diversity and inclusion in the financial sector – working together to drive change, July 2021
[14] FCA, FCA Mission: Approach to Consumers, July 2018

2 Healthy financial services industry

The actions of the regulators highlight that, to ensure the health of the financial services sector, diversity and inclusion need to be mainstreamed throughout regulatory processes. As indicated by the FCA's own research, there is a link between strong diversity and inclusion within a firm and the firm's standards of conduct and the consumer outcomes it produces.[16] In a speech exploring why D&I is of regulatory importance, Nikhil Rathi explains:

"[The FCA] care because diversity reduces conduct risk and those firms that fail to reflect society run the risk of poorly serving diverse communities. And, at that point, diversity and inclusion become regulatory issues."[17]

Charlotte Gerken, Executive Director of the Insurance Directorate at the PRA, highlights the lack of diversity and inclusion in the financial sector as a core challenge for the regulator, creating barriers to progress.

"Within firms, we – at the PRA and the Financial Conduct Authority (FCA) – believe that increased diversity and inclusion will advance our statutory objectives by resulting in improved governance, decision-making and risk management within firms, a more innovative industry, and products and services better suited to the diverse needs of consumers."[18]

Moreover, Sheldon Mills, Executive Director of Consumers and Competition at the FCA, emphasises:

"Dversity and inclusion are critically important to the FCA. Firms that are diverse and inclusive deliver better outcomes for shareholders, consumers and markets."[19]

[15] FCA, Why diversity and inclusion are regulatory issues – speech by Nikhil Rathi, March 2021.
[16] FCA, Review of research literature that provides evidence of the impact of diversity and inclusion in the workplace, July 2021
[17] FCA, Why diversity and inclusion are regulatory issues – speech by Nikhil Rathi, March 2021
[18] Bank of England, Adaptability and resilience in the mutuals sector - speech by Charlotte Gerken, October 2021
[19] FCA, A regulatory perspective: measuring and assessing culture, now and in the future, the role of purpose and the importance of D&I - speech by Sheldon Mills, September 2021

DEC 2021 – FEB 2022

CP21/36 A new Consumer Duty[20]

The FCA published a consultation to set a higher standard of consumer protection in retail financial markets, in which they align the Consumer Duty with the FCA's work to improve outcomes for consumers in vulnerable circumstances and on diversity and inclusion.

JULY – SEPT 2021

DP21/2 Diversity and inclusion in the financial sector – working together to drive change[21]

The FCA, the PRA and the BoE published a joint discussion paper calling on firms to progress their data collection on D&I by embedding metrics such as gender and ethnicity representation across their organisation.

JULY – OCT 2021

CP21/24 Diversity and inclusion on company boards and executive committees[22]

The FCA launched a consultation on proposals to improve transparency for investors on the diversity of listed company boards and their executive management teams. They proposed that in-scope companies publish standardised data on the composition of their board and most senior level of executive management by gender and ethnic background.

JULY 2021

Staff Working Paper No. 929 Gender, age, and nationality diversity in UK banks[23]

Using a novel regulatory dataset, the Bank of England conducted research into the impact of board and senior manager diversity of gender, age, and nationality in UK banks on bank outcomes. The primary findings suggested that gender and nationality diversity were related to positive risk and performance outcomes, whereas the reverse was true for age diversity.

MARCH 2020

DP20/1 Transforming culture in financial services – Driving purposeful cultures[24]

A collection of essays from industry leaders, professional bodies and culture experts explored the role of purpose in driving a healthy, sustainable culture. They argued that putting a clear, meaningful purpose at the heart of a firm's business strategy was important in developing a healthy culture.

In July 2021, the FCA published a consultation paper (CP21/24) on proposals to improve transparency on the diversity of listed companies' boards and executive management teams, and a joint discussion paper (DP21/2), in collaboration with the Bank of England, to examine the role the regulator can play to support and accelerate the pace of meaningful change on D&I.These initiatives seek to drive greater transparency through corporate reporting and data publishing, with the view that publicly available data on a firms' D&I will better inform investment decisions, and further incentivise firms to prioritise and maintain greater diversity on their board and within the wider organisation. Also having broader benefits in improved employee retention, corporate governance, and company performance.

[20] FCA, A New Consumer Duty: Feedback to CP21/13 and further consultation, December 2021

[21] FCA, DP21/2: Diversity and inclusion in the financial sector – working together to drive change, July 2021

[22] FCA, CP21/24: Diversity and inclusion on company boards and executive committees, July 2021

[23] Bank of England, Staff Working Paper No. 929: Gender, age, and nationality diversity in UK banks, July 2021

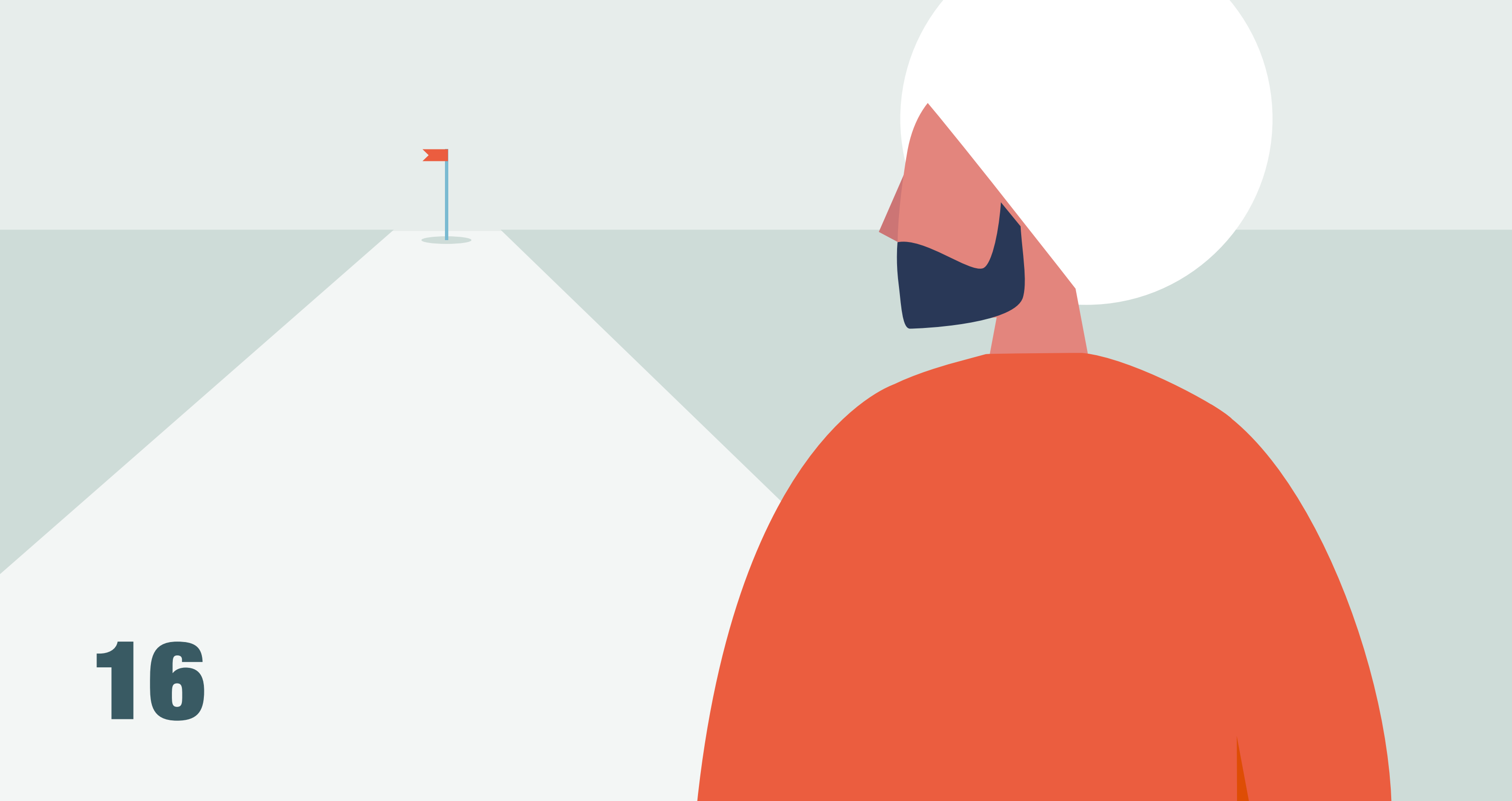
[24] FCA, DP20/1: Transforming culture in financial services – Driving purposeful cultures, March 2020

3 The future regulatory direction of travel

Following the publication of DP21/2, the FCA undertook a one-off survey to provide a benchmark to monitor future progress in this area, alongside further engagement with firms, other regulators, and stakeholders on this subject. In particular, the PRA and FCA intend to launch a further consultation on more detailed proposals with relation to D&I at the end of Q2 2022.

No new regulation has yet been announced off the back of the FCA's consultation on D&I on company boards (CP21/24) and the joint consultation on D&I across the financial sector (DP21/2). However, the discussion paper and the survey questions published at the end of 2021 do give an indication of what will be asked of firms, in terms of data and reporting. The availability of data and corporate reporting will be an essential component for the regulator to monitor progress in D&I, however the regulator must also be aware of the potential barriers in collecting, storing and accessing personal employee data which was strongly positioned in PIMFA's response to the DP and in subsequent conversations with the FCA.

More broadly speaking, in terms of Environmental, Social & Governance (ESG) factors, it is expected that the UK's Sustainability Disclosure Requirements (SDR) will help progress key items on the ESG agenda, one of which is D&I. The SDR will require corporate reporting to go beyond financial information and hold companies accountable for their ESG objectives.



THE IMPLICATION FOR FIRMS

Actions that firms **must** take:

Increase diverse representation, particularly in leadership roles. Beyond the social benefits, this will inspire alternative views acquired from more diverse experience, to produce more innovative ideas that can meet the needs of all consumers, including those from diverse parts of society. This will require a thorough review of existing recruitment processes, ensuring these are standardised and that job adverts are free from bias in terms of language used. Small businesses may face certain challenges in terms of representation. Clearly, small businesses should look to review their age, gender, disability, sexual orientation and cultural diversity and ensure an inclusive approach to their recruitment and career progression practices. However, there are other aspects to diversity – including social mobility and neuro-diversity. As such, small businesses should think about diversity in its broadest sense.

Define and implement a healthy corporate culture, which is promoted and led from the top-down but instilled at every level of the organisation. Effective leadership is paramount to engender an inclusive corporate environment. Senior managers should take direct responsibility for incorporating D&I throughout the organisation. Small businesses can demonstrate they are inclusive through more subtle practices, such as incorporating their discussion of inclusion into regular team meetings. Similarly, they can look to diversify their networks by joining industry affinity groups.

Put positive customer outcomes first. Organisations must place as much importance on guaranteeing positive customer outcomes as is placed on positive business outcomes. Moreover, as investors become increasingly concerned with their social responsibility, it is evident that customer and business outcomes are becoming more intertwined. While incoming regulation concerning D&I is yet to be established, it will certainly put consumer needs first. Businesses must ensure they are prepared.

Undertake a quantitative and qualitative internal review, so to identify and understand the processes and systematic shortcomings that have prevented D&I within the business, leading to greater accountability and solutions. Additionally, repeating this review on an annual basis will allow the organisation to assess the improvements made and areas still to be resolved, while creating an evidence base on firm efforts to progress.

Actions that firms **should** take:

Be transparent in setting targets for D&I within the business, both in terms of senior management and the wider workforce. Employees should understand how these changes will manifest and what effect this will have on them and their work. Transparency will encourage a healthy corporate culture by reducing uncertainty. For smaller firms a statement on D&I and your approach would be an indicator of your culture.

Work towards ensuring appropriate representation for other protected characteristics, such as disability and sexual orientation. Currently, D&I is focused on female, ethnic and cultural representation. While this is often put down to a lack of sufficient data on other protected characteristics, and the challenges in collecting such data, firms should still work to address this gap. For small businesses, simply stating that it is a diverse employer on its website will indicate to potential candidates that the business is actively seeking applications from individuals from diverse backgrounds.

Educate and reskill to remedy the systematic societal short-comings responsible for a lack of diversity within corporations. To access diverse talent, organisations should reach beyond traditional recruiting mediums. While small businesses may be unable to contribute on this scale, they can still promote D&I externally, getting involved in community education and local initiatives and providing a platform and visibility for their diverse workforce to inspire and attract the next generation.

CONCLUSION

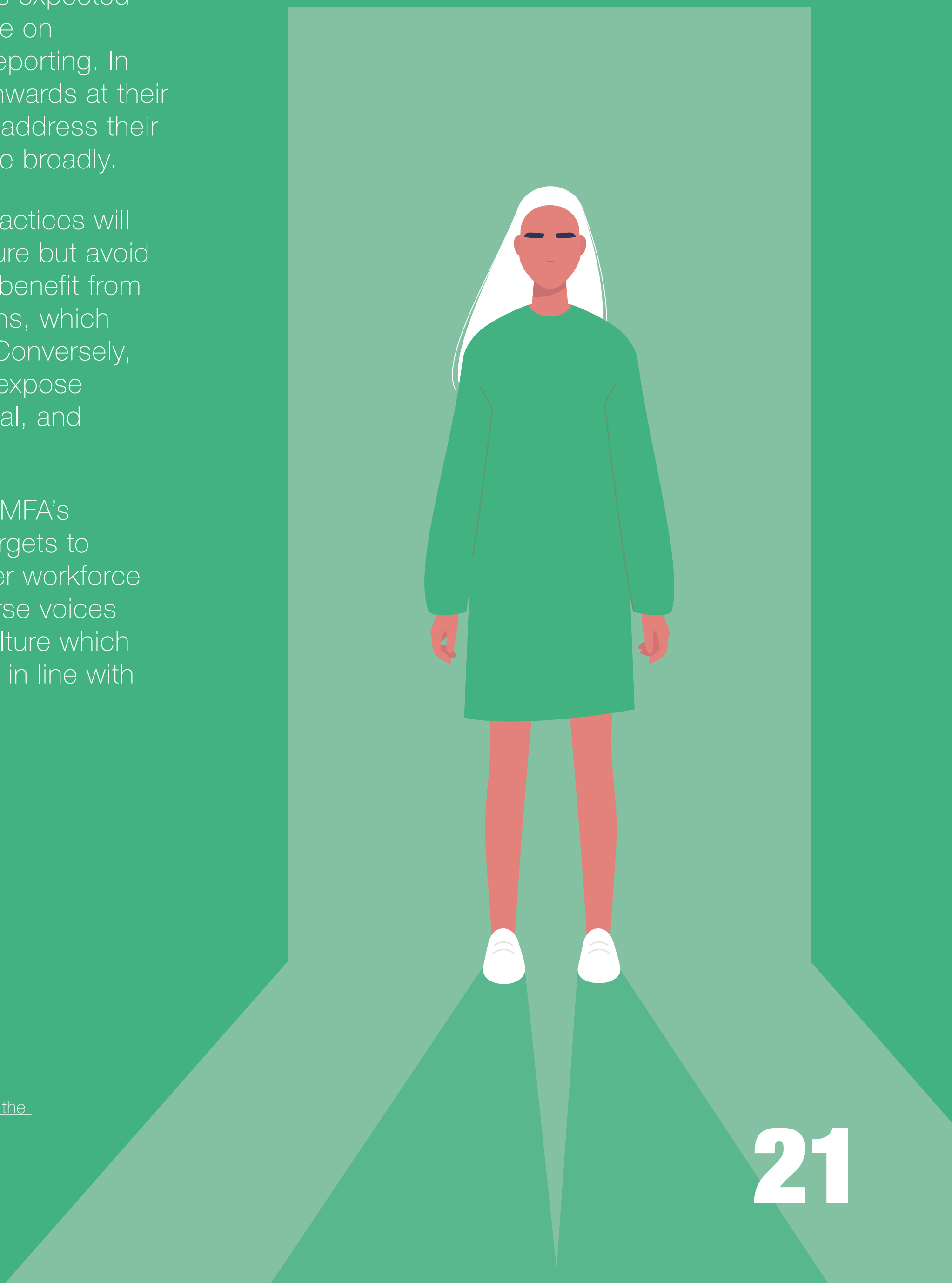
Risks for those left behind

Those that fail to diversify their workforce and foster a culture of inclusion will not only become vulnerable to increasing regulatory and investor scrutiny but see their business' performance suffer relative to the competition.

It remains unclear exactly how the UK's regulators will move forward in the D&I space, but what is certain is that the ethnic, cultural and gender diversity of boards is under the microscope. This focus will only increase throughout 2022 and beyond. It is expected that incoming regulation will centre on transparency through corporate reporting. In doing so, firms will have to look inwards at their internal processes and culture to address their D&I failings, and ESG impact more broadly.

Businesses that champion D&I practices will not only escape regulatory pressure but avoid the dangers of "group-think" and benefit from more innovative ideas and opinions, which will manifest in greater returns.[25] Conversely, the firms that fail to prioritise D&I expose themselves to financial, operational, and reputational risk.

To mitigate against these risks, PIMFA's members should set and meet targets to diversify their leadership and wider workforce and seek to empower those diverse voices through an inclusive corporate culture which puts positive customer outcomes in line with positive business outcomes.



[25] Refinitiv, Refinitiv Insight: Diversity and Inclusion in the Post-Covid World, September 2021

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