30 September 2021

LAPFF Response to the Bank of England, Prudential Regulation Authority and Financial Conduct Authority's Discussion Paper (DP21/2) – Diversity and inclusion in the financial sector – working together to drive change

Background

- The Local Authority Pension Fund Forum (LAPFF) is a voluntary association of 84 local authority pension funds and seven LGPS pools, with combined assets of over £300 billion. It exists to promote the investment interests of member funds, and to maximise their influence as shareholders to promote high standards of corporate governance and corporate responsibility amongst the companies in which they invest.

Response

- LAPFF welcomes the opportunity to respond to this timely discussion paper. The response outlines our overall position, with specific consultation questions being addressed in the following section.

- LAPFF has long made the case for diversity in the boardroom, at senior level and throughout the workforce on materiality grounds, supporting the principle of diversity across a range of employment characteristics. LAPFF policy states that board diversity 'discourages 'group think' which is vital if there is to be an effective challenge process. LAPFF is of the view that diversity can be linked to better problem solving, innovation and creative solutions, attracting and retaining better talent, reducing exposure to lawsuits, and better overall performance and decision-making at the strategic level.

Detailed response

Q1 What are your views on the terms we have used, how we have defined them, and whether they are sufficiently broad and useful, now and in the future?

The Discussion Paper (DP) provides useful definitions of the terms of 'diversity and inclusion'. LAPFF agrees that diversity alone is not enough. Appropriate inclusion means that 'everyone feels involved, valued, respected, treated fairly, and that these elements are embedded into a firm's culture'. There are examples where companies could be seen to have appointed people to attain a diversity quota but not actually encompass diversity and inclusion into the company ethos; something that the 30% Club Investor Group is focusing on currently.

Q3 Do you agree that collecting and monitoring of diversity and inclusion data will help drive improvements in diversity and inclusion in the sector? What particular benefits or drawbacks do you see?

LAPFF would agree with this; the collection of data is needed so that plans of improvement can be drawn up based on this. Following data collection and plans to drive improvement, targets can be set and progress against them measured.

As noted in the DP 'limited data inhibits high quality research of diversity across the board.' Furthermore, LAPFF would argue that without the collection and monitoring of data, it is not possible to compare companies on levels of diversity and inclusion. This in turn, makes evaluating a company's approach to diversity and inclusion more difficult. For example, a company's policy document might say the company promotes diversity and inclusion but if the data showed low levels of diversity then it would be evident that no measures were being taken to implement the policy. When measuring response rates to data collection, this also indicate how much trust employees have in their organisations and/or sector, with good and low response rates likely reflecting good and low levels of trust.

Q4 Do you have a view on whether we should collect data across the protected characteristics and socio-economic background, or a sub-set?

As noted in the introductory response, LAPFF supports the principle that data should be sought across a full range of protected characteristics, extending to but not limited to, socio-economic background. LAPFF's policy on diversity rests on two main arguments. First, that the lack of diversity encourages groupthink which can lead to poor decision making at board level (and it can also hinder innovation across the workforce). Second, that lack of diversity risks under-utilising talent whereas encouraging diversity widens and deepens the talent pool. The second also relates to the first because without a diverse pipeline of candidates, companies will struggle to fill senior and boardroom positions with diverse candidates. Theoretically increasing the socio-economic background of board members would increase the diversity of thought and experience. For example, socio-economic background is associated with differing attitudes to risk, altruism and patience.[1] As in the response to question three, without the collection of data on such a characteristic, it is hard to drive change related to this and promote better levels of diversity and inclusion.

Q5 What data could the regulators monitor to understand whether increased diversity and inclusion is supporting better decision making within firms and the development of products and services that better meet customers' needs?

Pulling together specific pieces of research in a number of areas such as case studies, such as that detailed in the DP (Arnaboldi et al) could help regulators understand the link to better decision making. Monitoring company performance specifically based on diversity and inclusion on a year-by-year basis is difficult to do, given the number of external factors that effect a company's performance. Research by McKinsey[2] (2016) estimated that bridging the diversity gap could add £150 billion to the UK GDP by 2025. Furthermore, a Department for Business, Energy and Industrial Strategy Analysis for the McGregor-Smith review found a potential £24 billion a year benefit to the UK economy of full representation of BAME individuals across the labour market, through improved participation and progression.[14]

Q8 Are there specific considerations that regulators should take into account for specific categories of firms?

Firm turnover and size should be taken into account when defining what firms should be subject to any regulation. Examples of where current regulation potentially fails the promotion of diversity can be found in the FTSE100 in relation to the mandatory publishing of gender pay gap reports for companies with over 250 employees. There are organisations in the FTSE100 that certainly have the resources to publish such a report but do not do so, as they have under 250 employees.

Q9 What are your views on the best approach to achieve diversity at Board level?

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[1] Deckers, T How Does Socio-Economic Status Shape a Child's Personality? IZA. April 2020

[2] https://www.mckinsey.com/~/media/McKinsey/Featured%20Insights/Women%20matter/The%20power%20of%20parity%20Advancing%20womens%20equality%20in%20the%20United%20Kingdom/Power-of-parity-Advancing-womens-equality-in-the-United-Kingdom-Full-report.pdf

An evaluation of how committed a company is to diversity should be considered. Factors that could be taken into account include boards having targets, plans and programmes that seek not only to increase diversity at board level, but throughout the entire workforce, thus elevating potential progression paths to seniority. This could take the form of mentoring or training programmes for a wide proportion of the workforce. In recruiting for senior leadership/board membership, boards should place an onus on head-hunters to provide a diverse list of candidates. LAPFF policy also takes the view that all new executive director positions should be publicly advertised to encourage robust competition for positions and improve the diversity of candidates,

From a stakeholder perspective, investors, as part of their stewardship responsibilities, have a role to promote meaningful diversity engagement. Broad stakeholder engagement is essential in promoting diversity at Board level and asset managers should also be encouraged to promote high levels of board diversity. Asset managers that have a more forward-thinking approach to their voting policies in relation to diversity, are able to contribute to a number of investor groups working on effective engagement on board diversity. Examples like Legal & General stating that they will vote against re-election of chairs of Nomination Committees if firms fail to meet the end-2021 deadline of the Parker Review recommendation, is a positive step in the right direction with regards to this. LAPFF supports both the Hampton-Alexander review and Parker review recommendations, which are to have 33% female diversity and one board member of a minority ethnic background respectively.

Q10 What are your views on mandating areas of responsibility for diversity and inclusion at Board level?

LAPFF agrees with the DP that 'boards are ultimately responsible for firms' strategy and culture'. LAPFF also agrees that targets for representation are a powerful method of driving change. LAPFF would support applying targets for under-represented genders at Board level, across a wider range of firms than the current significant banks, investments firms and other Financial Market Infrastructure firms (FMIs) that are currently required to set. THE FRC's report[3], published in December 2020 showed that 52% of FTSE250 companies failed to mention ethnicity in their board diversity policy and that most of the FTSE 350 did not set measurable ethnicity targets. It further showed that 3% of the FTSE 100 and 11% of the FTSE250 did not even have a policy on board diversity. Mandating for boards to have definitive diversity policies with explicit mentions of wider targets than those recommendations laid down in reviews, such as those in the Hampton-Alexander and Parker reviews, would promote better levels of diversity and inclusion at board level.

[3] News I Financial Reporting Council (frc.org.uk)

Q13 What are your views about whether all firms should have and publish a diversity and inclusion policy?

LAPFF believes that all FTSE350 companies should have to publish a diversity and inclusion policy.

Q14 Which elements of these types of policy, if any, should be mandatory?

LAPFF agrees that companies should disclose 'clear objectives, realistic goals, a plan for meeting those goals and ways for measuring progress' and that these should be mandatory. Best practice would be for companies to disclose yearly metrics and future plans for diversity.

Q15 What are your views about the effectiveness and practicability of targets for employees who are not members of the Board?

Given that board members are largely considered responsible for the culture and strategy of the company, responsibility for targets should lie with them and with senior executives subject to performance-based remuneration incentives. The impact of wider societal/structural issues should be considered as a 'practicability' factor when setting targets.

Q16 What are your views on regulatory requirements or expectations on targets for the senior management population and other employees? Should these targets focus on a minimum set of diversity characteristics?

LAPFF supports the 30% Club and the voluntary setting of commitments to improving boardroom diversity by striving to achieve the minimum 30% target of gender diversity on corporate boards. LAPFF would also like to see companies clearly set out their targets for the percentage of female representation at the executive committee levels and two levels below, as well as disclosure against these targets in order to measure progress against an established time frame. However, LAPFF does not believe that legislation is the best way to create sustainable, meaningful change in the area. Growing the female talent pipeline needs to be high on the agenda for every board and company. Recommendations like those of the Hampton-Alexander and Parker reviews seem more fitting than legislation. Through this lens, it is easier to identify where companies are making a more positive effort to incorporate diversity & inclusion into core business strategy, as opposed to being forced into doing it.

Q17 What kinds of training do you think would be effective for helping understanding of the diverse needs of customers?

Third party forums held with wide sets of stakeholders, including specialists on diversity & inclusion, stakeholders and customers would provide a good base to understand the diverse need of customers. Informal training days can then be formulated on the outcomes of these forums with employees and could be seen as a space for meaningful dialogue rather than formal training. This recognises that requiring employees to attend training can instil 'resistance'.

Q20 What are your views on whether information disclosures are likely to deliver impact without imposing unnecessary burdens? Which information disclosures would deliver the biggest impact?

LAPFF would argue that additional information disclosures of clear and comparable data are unlikely to impose unnecessary burdens on firms. They provide an essential start for anyone wishing to assess firms' approach to different aspects of business activities. Firm disclosures on diversity provide a clear statement of intent and for shareholders, a basis on which to hold companies to account if improvements are not made over time. If boards have a clear intention of embedding diversity and inclusion into the company business strategy, it would be reasonable to expect that they would not see this as a burden.

Information that would deliver the biggest impact would be clear and compatible statistics such as information across the protected characteristics as well as wider considerations such as socio-economic background, providing numbers and proportions of workforces, including the seniority of staff. Bigger firms could be expected to undertake a staff survey with related questions. If this was the means of providing data for disclosure, the proportion of employees responding could also be disclosed.

Q22 What should we expect firms to disclose and what should we disclose ourselves from the data that we collect?

We should expect firms to disclose as much information as possible on diversity & inclusion within their workforce without breaking privacy laws. Then with pressure being placed on individual firms to take action, which as noted in the response to question 16, would include companies clearly setting targets for the percentage of female representation at executive committee level and two levels below, as well as disclosure against these targets. LAPFF also supports the notion that companies disclose a description of the board's policy on diversity, with inclusion of the company's efforts to increase ethnic diversity within its organisation and board. This level of disclosure would change from firm to firm, potentially to be decided on the firms' capability to do so, based on a balance of size/profit/revenue.

Q25 Do you agree that nonfinancial misconduct should be embedded into fitness and propriety assessments to support an inclusive culture across the sector?

From an investor point of view, LAPFF is acutely aware of the potential material risks that non-financial misconduct brings, including reputational risk. Should this misconduct not be embedded into a fitness and propriety assessment, acts of discrimination or other misconduct may not be treated in the serious manner that they warrant. It would be hard to argue that a firm has a progressive stance on diversity and inclusion if for example, senior members of staff were seen to act in a manner considered contradictory to the company culture on D&I and not be reprimanded for such actions.