Investment

DP21/2 Diversity and inclusion in the financial sector

Working together to drive change

About us

Nest was established in 2010 as part of the auto enrolment programme to help people save for retirement. Unlike any other pension scheme in the UK, Nest has a legal obligation to accept any employer that wishes to use us to discharge their auto enrolment obligations. Over 900,000 employers have signed up to use Nest.

Over the last decade, Nest has grown to be one of the largest pension schemes in the UK. We are operating at scale as a high quality, low cost pension scheme helping over 10 million members save for their retirement. Many are low to moderate earners who may be saving into a pension for the first time. A typical Nest member earns around £20,300 per year and nearly half our members are under 35 years old.

Nest is built around the needs and behaviours of our members, from our approach to responsible investment to our focus on customer service. We now occupy a place in the market as a major Master Trust, helping to drive up standards and best practice across the industry. Nest has great potential for delivering pensions to mass market consumers for many years to come, leveraging our scale to deliver value through the combination of low costs, our market leading investment strategy and modernised services all overseen by strong trustee governance.

Response

We welcome the Discussion paper issued by the Financial Conduct Authority, the Prudential Regulation Authority and the Bank of England. We acknowledge too that regulators have brought emerging ideas and proposals forward for public consultation prior to the development of rules, to allow the widest possible range of stakeholders to participate – this inclusive approach is warmly welcomed.

Nest's primary involvement with the combined regulated community of the three organisations is with asset managers and our own fund managers are predominantly solo-regulated firms – that is, firms regulated by the FCA alone. Therefore, our response generally focuses on these firms, and does not cover, for example, Financial Market Infrastructure firms.

We support improved diversity in the financial services industry. We believe this particularly applies for asset managers, tasked by end-investors with engaging and voting on investee companies. To more effectively represent savers' interests, they need to become more representative of savers themselves.

In support of this belief, we are founding signatories of the Asset Owner Diversity Charter[1], committing to consider diversity and inclusion when appointing fund managers. Nest's head of responsible investment, Diandra Soobiah, is a co-chair of the 30% club investor group, and we have engaged with the Diversity Project to help others foster more inclusiveness within the industry.

[1] https://diversityproject.com/assetownerdiversitycharter

Nest as an organisation is built on a social purpose. As a public corporation we serve a broad membership that reflects the diversity we see in the UK and want to see this representation within our own workforce. We are committed to continually advancing diversity and inclusion across our organisation. We are signatories to the Women in Finance Charter and have released reporting on our gender and ethnicity pay gap and have set a number of targets for improvement within our diversity and inclusion strategy published last year. We have similarly high expectations of the organisations we procure and partner with which include our many fund managers.

This means that in our responses below we have favoured a more transparent public-facing set of proposals – for financial firms to make disclosures public to all rather than through aggregated industry-wide disclosures via Regulators. Given the wide evidence presented in chapter 1 of the importance of diversity to good governance and decision-making, asset owners and other clients need access to information as a consideration in short-listing and appointment decisions and in ongoing monitoring. Public disclosure will also enable civil society bodies to hold the sector to account, and will allow financial firms to benchmark themselves against peers within sub-sectors and across financial services as a whole.

We have only answered a subset of the questions, where we believe we have the most useful input to offer.

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?

We agree with the approach here. In particular we agree that diversity includes but is not limited to the protected characteristics set out in the Equalities Act. Socio-economic status is also a key aspect in cultivating diversity of thought and should not be deprioritised in any aspect of the Regulators' proposals.

We agree with the way that inclusion has been defined.

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?

We see significant benefits to the collecting and monitoring of diversity and inclusion data. As the discussion paper acknowledges, diversity data requirements are significantly different across the sector. Mandatory disclosure is extremely limited, and voluntary reporting approaches differ widely. We do not have a robust enough picture of the level of diversity across the protected characteristics or socio-economic background to reliably measure progress. The Asset Owner Diversity Charter which was launched by a number of asset owners earlier this year was developed to help improve disclosure on diversity beyond just gender. The annual questionnaire that asset managers will be expected to complete covers questions across a range of areas from the board, culture to recruitment practices and asks how managers are addressing barriers. We believe more transparency delivered over time by asset managers will lead to improvements in diversity and inclusion.

We have a different view from the emerging proposals set out in the Discussion Paper, in our belief that the data needs to be made public at firm level as well as being shared with the relevant regulator.

We do not see any drawbacks with the Regulators' proposals or our own adaptation proposed immediately above, other than the risk of unwanted identification. This is a challenge – employee privacy is important – but it is best decided by employees themselves rather than risk it being used by employers to hide behind identification concerns to withhold better public reporting.

Such concerns could be effectively managed through reporting with staff members' consent – that is, clarifying that individuals have the right of opt out in relation to disclosing diversity characteristics. There is a low risk that boards or senior managers at firms with poor data or poor records will seek to opt out in large numbers to obscure useful reporting, but civil society bodies, peers, investors and regulators will be able to draw their own conclusions and challenge firms appropriately.

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

We do not think there are strong grounds for prioritising some protected characteristics over others, and we think socio-economic background is also an important aspect of diversity which Regulators should monitor.

It could be contentious for Regulators to suggest that some characteristics are less important or somehow do not merit data collection. Clearly characteristics differ between those where distributions are closer to 50-50 (for example, sex) and those which apply to a much smaller group of employees (such as gender reassignment), but with the safeguard of opt-out explained above in response to Q3, we think any associated reporting challenges can be readily managed.

Q6: What are your views on our suggestions to approach scope and proportionality?

Q7: What factors should regulators take into account when assessing how to develop a proportionate approach?

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

We suggest that – at least in relation to FCA solo-regulated firms including asset managers – the SM&CR categorisation is used, not the Companies Act classification of small, medium and large.

The small, medium, large classification in the Companies Act relies on firms meeting 2 of 3 criteria relating to balance sheet, staffing and turnover. However, many significant asset managers do not have large numbers of staff *or* large balance sheets, [they only manage the assets, they do not own them]. Use of the Companies Act classification would result in many asset managers being classified as small or medium when they manage billions of assets on behalf of occupational pension schemes and other institutional investors.

Instead, we endorse the use of the SM&CR regime, under which diversity data collection, reporting and target setting apply to Core and Enhanced SM&CR firms.

Limiting the requirements to Enhanced SM&CR firms only– such as asset managers with £50bn or more assets - would only capture 34 asset management firms, based on the FCA's assessment in CP21/17, so limiting to this category would not be that helpful.

If the Regulators were minded to exclude smaller Core SM&CR firms, a threshold of £10bn in assets under management might be considered for fund managers.

Where the regime applies, we believe SM&CR status is the only factor or characteristic that the Regulators need to take into account.

We would welcome some clarification with regards to FCA-authorised Occupational Pension Scheme (OPS) firms and whether they are in scope. Nest Corporation's investment subsidiary, Nest Invest, is an OPS firm, which is already subject to SM&CR but doesn't have permanent employees and does not own any assets, so we would welcome clarification as to whether Nest Invest would fall into scope as an FCA solo-regulated firm.

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

We support the Regulators' suggestions around target setting. It is essential that these targets are publicly reported. We think that quantitative firm-set public targets, with accompanying policies and regular reporting, will be the most effective way of improving diversity at both board and senior management level.

Whist we welcome the publication and use of diversity policies and/or qualitative targets, we don't think they alone will be sufficient to drive the change that the Regulators – and Nest – wish to see. They will not make it possible for regulators, clients or civil society bodies to measure progress. Firms will be able to continue with warm-sounding but non-committal policies which can continue to be met whilst making minimal progress in measurable diversity outcomes.

Targets are therefore desirable, but need not be unduly prescriptive. We suggest a requirement for a minimum of one non-binding target in relation to a protected characteristic or socio-economic background, at board or senior management level. Firms will ultimately be judged by their current diversity levels and by the level of ambition of their targets, more than by "diversity is very important to us"-style policies.

Finally, of course, whilst we see targets as an important tool to help boards focus on the matter at hand and drive improvements on diversity, it is important that they are underpinned with work on cultural and structural issues that may have been acting as a barrier to diversity. An undue focus on meeting targets alone could lead to a tick-box approach and lack of buy-in from the whole organisation.

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

We believe boards should set the tone from the top on culture, values and purpose. This should include top level commitment on diversity and inclusion on which boards should mandate positive action across the organisation. We believe it should be the CEO and other C-suite executives who are responsible for the diversity and inclusion and how that is implemented across the organisation.

We believe that handbook guidance recommending a dedicated diversity resource for larger Core and Enhanced firms that reports into the CEO and C-suite executives would be a helpful addition. We provide further reasoning behind this in the response to the next question.

Q11: What are your views on the options explored regarding Senior Manager accountability for diversity and inclusion?

In line with our above answer, we support allocation of responsibility for board diversity to the Board itself, irrespective of whether a Nominations Committee is present. Boards should be required to

develop policy and set appropriate targets. Implementation of those targets and reporting against them should sit with the Nominations Committee.

This represents an advance on the existing gender requirements under SYSC 4.3A. Whilst it would involve limited disruption to those rules, it would send a signal that diversity sits with the whole Board and at the top of the organisation, rather than a subset of directors which is junior to the Board. We would expect this to help accelerate the progress that has taken place since these rules were introduced more than 3 years ago. Such a rule change can take the form of an expanded requirement for policy and targets to SYSC 4.3A.3 or 3A, and amending the rule at SYSC4.3A.9(4) to cover delivery and reporting of targets.

The argument might be made that the Board would be put in the role of "marking its own homework" by setting rules about its own composition. However, this same challenge might be made of the Nominations Committee, a majority of whose members should, under the Corporate Governance Code, be non-executive directors. It might in fact be suggested that it is the absence of executive directors in the setting and oversight of diversity targets which undermines the effectiveness of the current system.

To ensure expert input and advice into board target setting, ensuring policies and targets keep pace with best practice, we recommend the appointment of a dedicated diversity officer reporting to the CEO or another executive board member.

Where firms do not have a Nominations Committee, we agree with responsibility for implementation and reporting against diversity – as well as policy and target-setting – sitting at Board level.

Whilst we support in principle the idea of express allocation of responsibility to individual senior managers in the organisation, rather than the Board and Nominations Committee, we believe that this could create complex rules, given the wide diversity of roles in different organisations. Inevitable nuances in different roles and their descriptions could also potentially mean that responsibility was allocated sub-optimally. To us, this seems like a less essential part of the emerging regime, which overall we strongly welcome. In that sense, we would be happy to retain a regime under which responsibility continued to sit collectively with the Board and Nominations Committee, rather than focus unduly on implementing a more complex set of individual-level responsibilities.

Q12: What are your views on linking remuneration to diversity and inclusion metrics as part of non financial performance assessment? Do you think this could be an effective way of driving progress?

Whilst on the one hand this proposal, would discourage lip service alone and create incentives for change, we have concerns that this rather blunt form of inducement might encourage tick-box compliance, resulting in boards sacrificing quality in order to meet remuneration targets and earn their bonus.

The short termism of many remuneration packages might itself encourage short-termism in diversity considerations. We believe more long-term and sustainable results in culture change and diversity may be achieved through the Board owning diversity, recognising its benefits and responding to client demand for change and investor oversight.

We are also unconvinced that linking 'inclusion' to quantifiable metrics would work. Whilst representational diversity can be easily quantified and measured, how well individuals are valued and the effectiveness of decisions would not be amenable to such an approach. Research by ICAEW[2] backs up our view and presents other arguments against linking remuneration to diversity and inclusion.

We therefore do not favour the production of guidance or expectations on this point.

[2] Should remuneration drive diversity and inclusion? | ICAEW

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

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

We support a requirement that all firms should have to publish a diversity and inclusion policy. We believe that this could be applied to all firms subject to Core or Enhanced SM&CR. At a minimum, it should apply to larger Core firms (e.g. £10bn+ assets under management in the case of asset managers) as well as Enhanced firms.

Such a policy would not need to be overly prescriptive – for example a mandatory policy on each individual protected characteristic could be counter-productive and might encourage vague or "boiler plate" policies which are difficult to measure progress against.

However, we believe that firms should be required to publish a policy and they should be required to state any policy that they do have in relation to each protected characteristic, as well as socio-economic background, rather than be able to hold "private" policies which are not made available. The practice of private policies prevents firms from being held accountable by clients and civil society bodies, and prevents firms learning from their peers.

Similarly, the policy should set out objectives and all targets which have been set publicly, rather than there being private targets. It is important that the policy explains how these targets links to or impacts on the company strategy and how it will be implemented. Public reporting against such targets should also take place annually.

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

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?

We support non-binding targets for the diversity of senior managers in financial firms. We believe that this would be both effective and practicable, and would commit firms to real action, rather than believing diversity has been "done" with the appointment of one or two diverse non-executive directors.

We have not seen any compelling arguments that this should be any more difficult than with the board. The "2 levels down" approach used in the Hampton Alexander Review is reasonable.

To manage the risk that smaller firms end up reporting a larger proportion of their staff than traditionally thought of as "senior management", firms could additionally be required to report on the percentage of their staff in scope of their target setting under the "2 levels down" approach. This would enable the regulator, clients and others to identify the breadth and scope of the reporting, and ensure that they were comparing like with like.

We accept that targets in relation to every diversity requirement may be counter-productive and could be unsuitable for some firms. We therefore suggest that there should be a requirement to set at least

one quantitative target in relation to a protected characteristic or socio-economic background covering senior management.

We are unconvinced that targets are required for customer service staff specifically. There will be challenges with classification, and targets for firms with different business models will quickly become non-comparable – for example firms who have outsourced all customer service apart from senior strategic roles would be compared with firms with large internal staff with many more junior roles. Typically, the former organisation will perform worse on quantitative measures of diversity, but it may actually be doing better on an “apples and apples” basis.

However, we note that there are challenges in certain roles in financial firms, such as portfolio management teams in the asset management sector, and that roles in investment management, risk and operations are particularly non-diverse. These are the issues that the Asset Owner Diversity Charter has been established to address. Here we would recommend handbook guidance which sets expectations of Boards in large Core and Enhanced SM&CR firms to consider other areas of their business where their workforce is significantly less representative of the end beneficiaries they serve, and to set targets and report as appropriate.

On the whole senior manager and board diversity targets are more immediately relevant and comparable than wider workforce diversity, as well as the data being easier to collect, but as data and technological solutions to collate data improves we would expect the scope of disclosure to widen over time.

Q19: What are your views about developing expectations on product governance that specifically take into account consumers’ protected characteristics, or other diversity characteristics?

We do not support this in relation to institutional business, where we would see this as something the trustees of occupational pension schemes, or corresponding governance bodies in other asset owners, have the responsibility to act in savers’ interests. Other areas of the financial firm landscape will have a similar “business to business” service model where tailoring to consumers’ protected characteristics would not be meaningful or may even be impossible for FCA, PRA or Bank of England-regulated firms who will in some circumstances not even know their end consumers. In this instance, we would expect service providers to respond to asset owner demand for products which take into account their own beneficiaries’ or consumers’ preferences.

Such expectations may be more meaningful and more appropriate in direct consumer relationships, such as retail banking products.

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?

Q21: How should our approach for information disclosure be adapted so that we can place a proportionate burden on firms?

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

We think the costs of disclosure are negligible. The costs of collection and analysis of data are not negligible, but they are low. Firms will be using modern HR management systems which almost universally include data collection functionality on diversity, and salary information, with associated reporting functionality.

Given that the Regulators are proposing that firms collect data on diversity at Board and Senior Management level and make this available to the Regulator, we think the minimum for all firms in scope is to make that data publicly available, on an annual basis, along with policies and targets, and this should be low effort to publish.

Larger firms – for example Enhanced firms under SM&CR – might be required to publish pay gaps for other diversity characteristics, as well as socio-economic background. This form of reporting would contain marginally more analysis, especially for diversity characteristics with multiple values such as age. Regulators might also consider making public a review milestone after the requirements come into force, at which point they would consider extending the requirements to some or all core firms under SM&CR. This would assist in giving the sector some certainty about possible timescales.

If the data is made publicly available, Regulators would have the information to hand to allow them to aggregate the data in whatever way they deem fit. We do not see any need for Regulators to fetter their discretion at this stage by indicating what aggregate data they plan to publish, but it would be beneficial for them to set indications of the sorts of data they propose to publish. In addition, they could helpfully publish the raw data in such a way to allow third parties to carry out their own analyses. They would be no need to anonymise the data, since it would be purely a collation of data which firms were in any case required to publish.

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

We support this proposal. We agree it is entirely appropriate that adverse findings in relation to individuals' conduct with respect to diversity and inclusion issues – such as sexual harassment, bullying and discrimination – are taken into account in the "fit and proper" test, and support the development of guidance, particularly if this can be put onto a stronger footing in the form of handbook guidance.

Q26: What are your views on the regulators further considering how a firm's proposed appointment would contribute to diversity in a way that supports the collective suitability of the Board?

Q27: What are your views on providing guidance on

how diversity and inclusion relates to the Threshold Conditions?

We do not favour these proposals. Whilst the current situation in relation to diversity in financial firms is far from ideal, it is premature to be considering giving regulators power to intervene to block senior manager appointments which would not contribute to diversity, or deem firms as not fit and proper for their handling of diversity issues. It will make for considerably improved outcomes if firms are given the opportunity to recognise the benefits of diversity and inclusion in their organisation, and "own" the steps to improve it, through the nudge of mandatory reporting and non-binding target-setting.

Armed with this reporting, clients, customers and civil society bodies are well placed to apply pressure to laggards and to recognise successes.

Q29: What impact do you think the options outlined in this chapter, alongside the FCA's proposals for a new Consumer Duty, would have on consumer outcomes?

As set out above, and in chapter 1 of discussion paper, there is ample evidence of better governance and decision-making in groups and firms which nurture a culture of diversity of thought.

In heavily intermediate sections of the financial industry such as pension investment, there are instances where outcomes are only good as the weakest link in the chain – where savers rely on asset management firms who deprecate diversity and see groupthink as a strength, it does not matter how strong or effective the consideration of these issues by trustees and insurers are. That is why it is essential that these intermediaries have access to key indicators such as the diversity of boards, senior managers, and where possible pay gaps across many protected characteristics.

Other parts of the investment landscape depend heavily on everybody pulling their weight. In stewardship of investments, fund managers do not recognise the benefits of diversity in investee firms and leave engagement to others which creates a free rider problem and discourages other participants from investing in the stewardship function.

Competition has a role to play in identifying high performers and raising overall standards. But firms should not be able to opt out of diversity and inclusion. It should be a minimum expectation and standard across all marker participants. And when that is the case, markets will be more effective, economic output will increase and the quality of saver and other consumer outcomes will improve.

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