

Insights

UK REGULATORS AND BANK OF ENGLAND TO POOL CONSIDERABLE POWERS AND RESOURCES TO ADVANCE D&I

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SUMMARY

Yesterday's joint Discussion Paper (DP21/2) published by the Bank of England, Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA, together "the regulators") on "Diversity and inclusion in the financial sector – working together to drive change" signals a step change in the degree of regulatory focus upon diversity and inclusion in financial services in the UK. While this theme has featured increasingly in FCA and PRA speeches – most pointedly in the speech by Nikhil Rathi on 17 March 2021 entitled "Why diversity and inclusion are regulatory issues" – yesterday's DP points to a desire on the regulators' part to create new regulation and to use their "hard/soft" supervisory powers to drive D&I improvements via the existing regulatory framework.

We welcome the regulators' joint efforts to clarify their expectations in relation to these critical topics and engage with all stakeholders on how to increase diversity and inclusion across the financial services industry in a sustainable way. As the regulators signal, the challenge will be doing this in a proportionate way reflecting the diversity of the financial services industry itself and in a way that is sensitive to existing requirements and pending proposals (including the FCA's proposals for a new Consumer Duty, which we discussed in our separate [blog](#)). Below we highlight six of the key points that emerge from the DP.

1. CLEAR REGULATORY ALIGNMENT

The Bank of England, the PRA and the FCA are now speaking with "one voice" on the importance of improving D&I as a risk management strategy, in recognition of the fact that more inclusive firm cultures, which are receptive to their employees' views, are likely to generate better judgments and decision-making. In their words, "we believe that more diverse and truly inclusive firms will benefit from better risk management, as individuals will feel more empowered to have open discussions and debates, without fear of having their views shut down. It should mean that concerns about

imprudent practices are more likely to be raised and acted upon.” We can be certain that with genuine regulatory alignment, there will be significant progress in the next year towards achieving their target of a Policy Statement with new rules in Q3 2022.

2. EMBEDDING PSYCHOLOGICAL SAFETY

The regulators are clear that improvements in diversity will only deliver the intended risk management benefits if boards and senior management also embed an inclusive culture within their firms, specifically a culture of “psychological safety”. The subject of psychological safety has for some time been part of the FCA’s “culture and governance” cross-sector focus, while the PRA has previously stressed the importance of a “psychologically safe” environment in addressing poor practices or identifying risks, including in relation to a firm’s financial soundness. The DP highlights that any progress will be difficult without a safe culture: “Psychological safety is an essential first step to creating an inclusive culture. Without this, an organisation may try to be inclusive but staff may be unwilling to speak up and raise concerns. People must also believe that diverse perspectives will be welcomed and heard.” The consistent message here is about actively fostering the right culture at all levels within firms and across the full lifecycle of firms’ activities.

At BCLP, we have been pleased to deliver a practical and interactive board training session to many clients on embedding a culture of psychological safety. Please contact us if you are interested in finding out about this session.

3. INCREASED DATA COLLECTION AND REPORTING

The regulators are seeking to explore how regular reporting and enhanced disclosure can help monitor and drive progress. Data on many aspects of diversity in financial services is believed to be lacking which makes it difficult to assess the extent of the issues and select the most appropriate interventions. To address this gap, they are considering requiring authorised firms to complete D&I regulatory returns, to include:

- Membership of Board and executive committees;
- Demographic diversity of Board and senior management;
- Demographic diversity of workforce;
- Whether there are internal diversity targets for the Board and senior management, and progress against targets; and
- High-level firm-wide data on demographic diversity characteristics and inclusion practices.

This prospective new reporting requirement will be subject to a pilot study, involving a one-off voluntary data survey, later this year. The regulators intend to survey a representative sample of

solo-regulated firms, all firms jointly regulated by the PRA and FCA and selected financial market infrastructure firms.

4. GUIDANCE ON NON-FINANCIAL MISCONDUCT AND SM&CR

The PRA and FCA intend to continue their “assertive supervisory focus on non-financial misconduct under the Senior Managers and Certification Regime (SM&CR)”, with a particular focus upon misconduct that is discriminatory in nature. This includes harnessing the power of individual accountability in the form of the SM&CR to drive change, including by the regulators:

- clarifying that the Prescribed Responsibility for SMFs to develop and embed the firm’s culture in dual-regulated firms includes responsibility for driving D&I. And, for solo-regulated firms, tweaking the SM&CR to include an express allocation of responsibility within Senior Managers’ Statements of Responsibilities for D&I policies; and
- providing much-needed clarity on what constitutes non-financial misconduct, thereby assisting firms in assessing individuals’ conduct against these behaviours and determining actions regarding individuals and disclosures in future regulatory references. The BCLP regulatory team will be responding promptly to the DP to support the need for this guidance.

5. LINKING REMUNERATION AND D&I

Many firms already align progress around culture, including D&I, to performance for the purpose of assessing remuneration (although typically only for the most senior executives). More specifically, CRD V has recently codified requirements around gender-neutral remuneration policies and practices, to the extent these were not already in place. Building on this, the regulators are suggesting that the remuneration policies for Senior Managers may also be required to take progress against D&I metrics (to be defined) into account, for example as part of the non-financial criteria when setting a variable component of remuneration. More generally, the regulators confirm that it is clearly fundamental that remuneration policies do not themselves result in discriminatory practices.

6. SPECIFIC D&I TARGETS

The regulators are considering setting specific regulatory requirements or expectations for firms to have D&I targets in respect of their boards and senior management, and for the wider firm. They are also considering a related proposal of taking a firm’s D&I profile into account when considering applications for approval for new SMFs and, further, when considering whether a firm is meeting its “threshold conditions” (i.e. the set of minimum requirements that a firm is required to meet in order to become and remain authorised by the PRA and/or FCA). Given that a breach of the threshold conditions empowers the PRA and FCA to reach into their supervisory toolkits and use their own-initiative variation of permission and requirement powers, this final proposal could potentially have a very significant impact upon regulated firms in the future.

CONCLUSION

Over the coming days and weeks, we will be undertaking further analysis and engagement on the far-reaching topics invoked in the DP. We would welcome conversations with you on the regulators' proposals. What will this mean for you and the financial services industry generally? What practical issues or concerns do you have about implementing the ultimate proposals? What should you be doing now and over the coming months? In the spirit of D&I, we are keen to engage in discussion across the financial services sector.

RELATED PRACTICE AREAS

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