ICS INSURANCE COMPLIANCE SERVICES LTD


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## Diversity and Inclusion in the Financial Sector – what is the FCA expecting of 'small firms'?

**Environmental, Social and Governance (ESG) issues are rising to the top of the agenda for corporates, investors, and wider society, and the issues of diversity and inclusion are viewed amongst the 'social' considerations.**

**Against this backdrop, in July 2021, the Bank of England, the PRA and the FCA set out a series of potential guidelines in a Discussion Paper - DP21/2 Diversity and inclusion in the financial sector - working together to drive change. Alongside this, the FCA published a Consultation Paper CP21/24 - Diversity and inclusion on company boards and executive committees, and followed it up with Policy Statement PS22/3 in April 2022.**

**The FCA subsequently published a Consultation Paper in September last year, CP23/20 - Diversity and inclusion in the financial sector – working together to drive change. The Consultation is now closed and the FCA intends to publish a Policy Statement in the second half of 2024.**

### Background

A lack of diversity in financial services was highlighted as a factor in the 2008 financial crisis. Looking at risk management outcomes, studies that compared the outcomes between diverse and non-diverse Boards following the crisis found that businesses with more diverse and risk-averse Boards had better outcomes. In the insurance sector, the FCA believes that not enough has been done. On 30th October 2023, the FCA held a joint webinar with the PRA to discuss their proposals on diversity and inclusion in the financial sector, and you can view a recording of the webinar here.

Diversity and inclusion are central to firms' roles as businesses and employers. The regulators have been taking increasing steps to enhance diversity and inclusion within the financial sector, for example through a more assertive supervisory focus on nonfinancial misconduct under the Senior Managers and Certification Regime (SM&CR) (as proposed for all firms under CP23/20), and the integration last year of gender-neutral pay polices in the dual-regulated firms' Remuneration Code.

#### What has the FCA found in smaller firms?

In the current CP23/20 Consultation, most of the requirements affect firms with over 250 employees, which are referred to as 'large firms'. Those firms with 250 employees or less, on average during a year, will be classified for these purposes as 'small firms'.

The average number of employees is calculated over a three-year period by taking the total number of employees as at the calendar day on which the final rules are published in each of the three most recent years, and calculating the arithmetic mean of those numbers.

Most of the regulatory commentary and requirements in relation to DE&I have focussed on larger and listed firms, evidenced by the focus on Boards and Company Executive Committees in the April 2022 Policy Statement, and the significant focus on larger firms in the current FCA Consultation.

In December 2022, though, the FCA published a web page titled 'Understanding D&I in financial services' in which it published data split between larger (more than 250 employees) and smaller (250 employees or less) firms.

The data in the page could be interpreted as indicating that small firms are lagging far behind large firms in almost every element of embedding DE&I. The data could also be interpreted, though, as showing that small firms genuinely struggle to be able to accommodate any significant element of diversity or inclusion. All firms, though, can embed equality.

As an example, under the heading of senior manager accountability, the question "Do one or more of your firm's senior management have a diversity and inclusion objective?" was answered by small firms as follows:

No – 77%

Yes – 14%

Not answered – 9% (so most likely the 77% is 86%)

## What are the FCA's proposed new requirements?

To concentrate on the current CP23/20 Consultation, and also on the requirements for smaller firms (so 250 employees or less), the FCA's proposals would add one item of reporting and amend three Sourcebooks:

- FIT ('Fit and Proper test for Employees and Senior Personnel');
- COCON (Code of Conduct – or the 'Conduct Rules'); and
- COND (The Threshold Conditions)

The FCA is not proposing to change the scope of these Sourcebooks in relation to which *firms* are in scope, so if a firm is not currently within scope of these Sourcebooks, then the proposed changes would also not apply to them.

There are three main proposals which relate to non-financial misconduct, the Threshold Conditions and data reporting.

### Non-Financial Misconduct and the Threshold Conditions

The FCA is clarifying and strengthening its expectations around non-financial misconduct, which will apply to all firms across the financial services sector. The FCA has set out proposals to better integrate non-financial misconduct considerations into:

- staff fitness and propriety assessments;
- the Conduct Rules; and
- the suitability criteria and guidance for firms to operate in the financial sector (the Threshold Conditions).

*Fitness and Propriety*

The FCA proposes to add a new section to the FIT Sourcebook which will explain in more detail how non-financial misconduct forms part of the Fit and Proper test for Employees and Senior Personnel. The regulator's views are that bullying, harassment, sexual or racially motivated offences and similar misconduct within the workplace is relevant to fitness and propriety and that similarly serious behaviour in a person's personal or private life can also be relevant.

**Actions for firms:** Ensure that all staff, at all levels, understand the types of non-financial misconduct that will impact whether they are deemed fit and proper to perform their role, and that such misconduct may not be limited to that which happens in the workplace.

*The Conduct Rules*

The FCA proposes to make changes to the Conduct Rules by adding guidance on:

1. the types of behaviour that would fall within the expanded scope of COCON, and that may breach the Conduct Rules; and
2. what conduct is out of scope because it relates to an employee's personal or private life.

It should be noted that not every instance of misconduct towards a colleague will amount to a breach of COCON; only serious misconduct would amount to such a breach; factors including the duration and repetitive nature of the conduct and the extent of the impact on the subject of the conduct should be taken into account.

**Actions for firms:** Ensure that all staff, at all levels, understand:

- the types of non-financial misconduct that may lead to a breach of the Conduct Rules;
- what might be viewed as a serious breach of the Conduct Rules, and which may lead to disciplinary action; and
- the potential impacts of such breaches.

*The 'Suitability' Threshold Condition (TC5 – see COND 2.5)*

The FCA is proposing to extend the guidance on the Suitability Threshold Condition to include, for example, offences relating to a person or group's demographic characteristics (such as sexual or racially motivated offences) and tribunal or court findings that the firm, or someone connected with the firm (such as a director), has engaged in discriminatory practices.

**Actions for firms:** In considering ongoing compliance with the Threshold Conditions, ensure that HR practices (bearing in mind the complexities of employment law in general) include clarity on gathering information, on an ongoing basis, that can assist with the assessment of fitness and propriety, both of individuals and of the firm.

## Data reporting

All firms with a Part 4A permission (excluding Limited Scope SM&CR firms) will need to report their average number of employees annually, using a single data return (referred to as 'REPxxx Diversity and Inclusion' for indicative purposes at this stage, until the FCA finalises its rules and allocates a 'REP' number) on the RegData platform.

Where a firm's average number of employees is 250 or fewer, it is not required to complete any other parts of the return but may do so on a voluntary basis if it wishes to.

A sample template of the report has been provided on the FCA website – you can download a copy here. Further information on how the reporting will work can be found within the FCA Consultation.

## How can small firms adapt? Culture is the key.

In the FCA's view, firms are likely to struggle to make sustainable, meaningful change without greater attention to culture, and understanding the steps needed to prevent behavioural bias and discrimination.

As mentioned above, a good number of firms rely on outdated practices that no longer fit a modern, multi-cultural and diverse workplace; welcoming different perspectives is critical to an inclusive culture. Inclusivity should mean that everyone feels:

- Involved
- Valued
- Respected
- Treated fairly
- Part of the workplace

Experts and advocates for Diversity, Equality and Inclusion encourage businesses to consider some of the following:

- Resources – giving employees the support they need including advocates for inclusion, employee resource groups, policies such as mental health, menopause, flexible working etc, which help to create an inclusive environment.
- Having a voice – focus groups which allow contribution from staff to policies and support needed, encouraging means by which staff can contribute to matters they are interested in.
- Learning & development – staff need to feel that they have a career so there needs to be visible investment in their development. It doesn't always have to be by financial funding but can simply be by encouragement and providing time for development to take place.
- Equal pay – regular checks undertaken across an organisation to ensure this is happening.
- Collaborative environment – people feeling part of a team and sharing in success.

## So what can smaller firms do?

✓ Individual accountability – ensure that responsibility for DE&I issues is allocated to an appropriate member of the firm's senior management (an SMF holder).

✓ Develop a DE&I Policy amid a wider strategy and initiatives.

✓ Strive for inclusive representation at the most senior management / board level.

✓ Give employees the support they need, including advocates for inclusion, employee resource groups, policies such as mental health, menopause, flexible working etc.

✓ Consider how to engender psychological safety and welcome different perspectives.

✓ Understand and address behavioural biases.

✓ Equal pay – regular checks should be done across an organisation to ensure this is happening.

✓ Consider the suggestions in the Financial Services Skills Commission's Inclusion Measurement Guide.

✓ Consider sources of qualitative feedback such as employee focus groups or exit interviews, and encourage means by which staff can contribute to matters they are interested in.

✓ Ensure that all staff understand the implications of non-financial misconduct.


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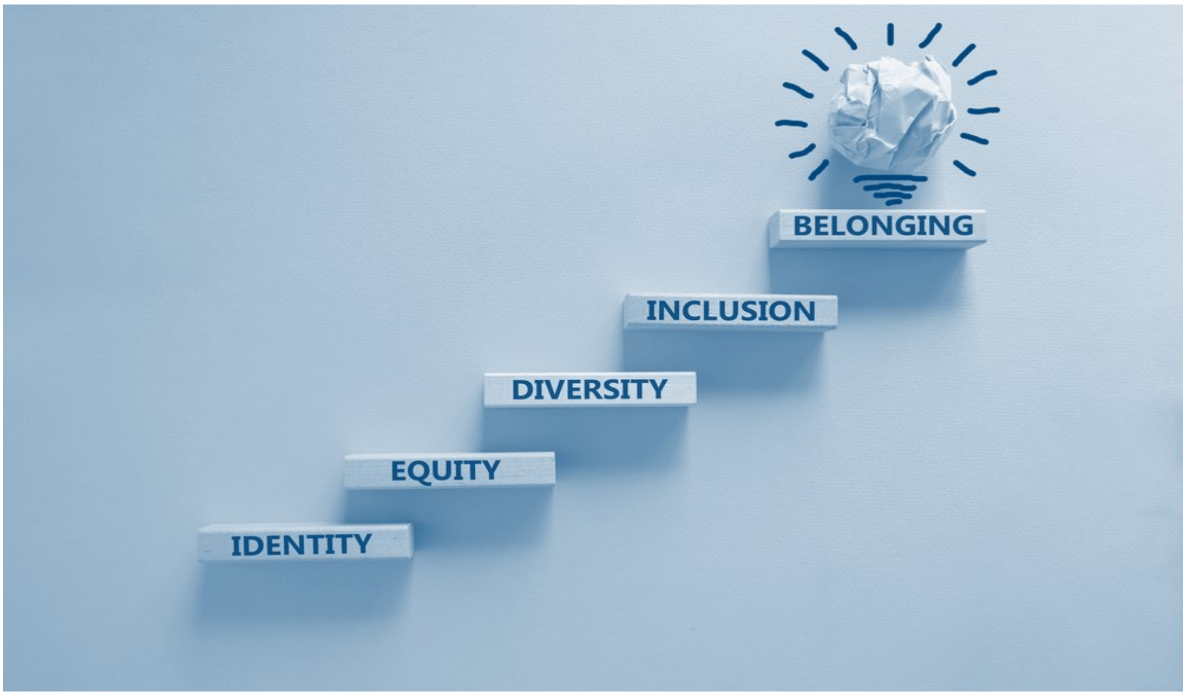


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The above information is a summary of certain matters which will affect the majority of firms conducting Insurance Distribution and reflects ICS's views at the date of publication. Each firms' requirements are individual, and rules are regularly changing; it is therefore important that you always seek specific advice from ICS before acting on anything contained in this publication.

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