Bank of England
Threadneedle Street
London
EC2R 8AH

29 September 2021

AFM Response to PRA DP2/21- FCA DP21/2, diversity and inclusion in the financial sector

1. I am writing in response to this consultation paper, on behalf of the Association of Financial Mutuals. The objectives we seek from our response are to:

   - Comment on the proposals, and highlight the work AFM and members are already undertaking;
   - Assess the potential consequences, for AFM members and their customers, of the issues explored.

About AFM and its members

2. The Association of Financial Mutuals (AFM) represents insurance and healthcare providers that are owned by their customers, or which are established to serve a defined community (on a not-for-profit basis). Between them, mutual insurers manage the savings, pensions, protection and healthcare needs of over 30 million people in the UK and Ireland, collect annual premium income of £19.6 billion, and employ nearly 30,000 staff[1].

3. The nature of their ownership and the consequently lower prices, higher returns or better service that typically results, make mutuals accessible and attractive to consumers, and have been recognised by Parliament as worthy of continued support and promotion. In particular, FCA and PRA are required to analyse whether new rules impose any significantly different consequences for mutual businesses[2] and to take account of corporate diversity[3].

[1] ICMIF, https://www.icmif.org/publications/market-insights/market-insights-uk-2016
[2] Financial Services Act 2012, section 138 K: http://www.legislation.gov.uk/ukpga/2012/21/section/24/enacted
[3] http://www.legislation.gov.uk/ukpga/2016/14/section/20/enacted

AFM comments on the proposals

4. We are responding on this issue jointly to PRA and FCA. We have also included comments relative to FCA CP21/24 'Diversity and inclusion on company boards and executive committees', as our members are mutually-owned and therefore out of scope of CP21/24- and we will not therefore be responding directly on that.

5. We consider the discussion paper to be a valuable contribution to industry thinking on diversity and inclusion. Based on our, and our members', experiences, diversity and inclusion are amongst a range of significant issues- also including climate change and ESG; the Consumer Duty; and operational resilience- that are causing firms to re-evaluate their culture and purpose, to ensure they remain appropriate to the markets and the members/ customers they serve.

6. There is a difficult balance in all these initiatives for AFM members to strike- to enable firms to fully embrace change, and to explore for themselves how best to incorporate important changes to the way they operate. For small organisations in particular, we encourage the regulators to be patient, consultative and constructive in their approach.

7. We have responded to the questions raised in the consultation below, and would welcome the opportunity to discuss further the issues raised by our response.

Yours sincerely,

Martin Shaw
Chief Executive
Association of Financial Mutuals

AFM responses to questions raised in the paper

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 broad definitions of diversity and inclusion adopted in the paper. There is a danger of thinking too narrowly, particularly when applying terms to consumers as well as to employees.

Our interpretation of paragraph 1.22 is that firms need to consider how effectively they embrace diversity, and that this cannot be a process of simply ticking boxes to demonstrate representation amongst customers, and employees, of different diversity groups. For example, a mutual insurance company with fewer than 20 employees may be able to meet the expectation that "firms need to be sufficiently diverse and inclusive to understand and meet the needs of their diverse customer bases", without the need to demonstrate its employee base- let alone its customer base- display all facets of diversity. What is key is that they inform decisions by taking account of a broad range of diversity criteria, and adopt a diversity of thought, as expressed in paragraph 1.14.

It isn't clear though how this is reconciled with some of the target-setting explored elsewhere in the discussion paper, and moreso in FCA CP21/24. We would appreciate clarity on this, and if FCA is minded to set targets or even lead indicators, it must take account of the difficulties in applying them in a small mutual, or other small firms.

We also observe that most of the examples set out in Chapter 1 are readily applicable to large organisations, but that the regulators and other bodies do not ordinarily engage with small organisations in the development of new initiatives. As a result, it becomes very difficult to adapt solutions set at a FTSE100 level to small organisations. Whilst by comparison to most AFM members, FTSE350 companies are not small, the data included in Box 1 reveals the difficulty in expecting standards established for the biggest organisations, to be realistically and effectively adopted to the operating environment in smaller businesses.

Again we think this is worthy of more study, and suggest a more bottom-up, rather than trickle-down, approach would be useful in engaging the entire financial sector. We understand PRA and FCA held a roundtable for firms in mid-September, at which the challenges of addressing diversity initiatives in small firms was widely discussed; however AFM was not invited to participate, so we remain concerned these issues are not considered in the round. FCA has been reluctant to engage with our members and sub-sector on a host of issues, and as a result, rules established on issues like climate change and GI pricing address issues in larger insurance firms adequately, but fail to reflect the reality of small insurers.

Q2: Are there any terms in the FCA Handbook, PRA Rulebook or Supervisory Statements or other regulatory policies (for any type of firm) that could be made more inclusive?

The paper highlights a lack of diversity as contributing to the depth of the 2008/9 financial crisis. We agree, in so far as many large banks and insurers acted in a similar way, to reduce losses and to reduce risk. In fact, during that same period, mutual insurers grew market share rapidly- from around 4% in 2007 to more than double that by 2010- because they didn't have to protect capital and profits, and as a result to safeguard the dividend for shareholders. Demand for products from mutual provider grew therefore, because they were prepared to continue serving customers.

As we highlight in the section 'About AFM and its members', both PRA and FCA have a legal obligation to take account of corporate diversity. We see very little evidence of this in practice: neither regulator reports in their business plan or accounts on how they have discharged their responsible to take account of corporate diversity in all their activities, and whilst they include a statement in consultation papers about the differing consequences of new rules for mutuals, invariable this takes a standard wording and displays very narrow thinking.

We consider a 'diversity of thinking' should also include an appreciation of how different business forms can achieve better customer outcomes. This might include by increasing competition in a particular business line, or improving access for underserved/ less affluent consumers, who are often outside the target market for the big banks and insurers.

Instead of embracing corporate diversity as an opportunity to secure better outcomes, regulators create barriers to the continued success of existing mutuals. The business start-up units regularly publish information proudly proclaiming the number of new banks and insurers they have helped initiate, but most of the challengers that have been through the units are smaller variants of the existing market players, and not a single one of the firms they have helped incubate has been mutually owned. Where mutuals have a proud history of delivering financial services to those poorly served elsewhere in financial services, we think the obstacles to new businesses may affect consumer access, particularly for the more vulnerable. We consider that the regulators' approach to *corporate* diversity shows an unhappy record, and one which diminishes good work elsewhere on diversity.

On the basis of 'what gets measured gets managed', we consider a commitment from PRA and FCA to report in their annual report and accounts on how their policy and supervisory work in the year has advanced its commitment to corporate diversity- and specifically mutuality- would be a helpful and practical step forward.

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?

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

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?

In Chapter 3, the document refers to expectations in the FRC Corporate Governance Code. AFM's equivalent Code is established for mutual insurers on an 'apply and explain' basis, whereby members report against six overarching principles, in their report and accounts. With respect to board diversity, the AFM Code includes:

> "2.5. Appointments to the board will demonstrate effort to establish an appropriate balance of expertise, diversity and objectivity. A policy on board diversity can helpfully support appointments to the board and succession planning. Diversity characteristics a board may consider include, but are not limited to, gender, social and ethnic backgrounds, and cognitive and personal strengths."

Alongside the AFM Code, we have been collecting data on board composition for several years. Until recently, the data collected on board diversity was restricted to gender, but for 2020 we asked members to report on ethnicity and disabilities.

We also recently sponsored research into board recruitment, and presented that to members in a webinar earlier in 2021. This found that from a sample of new NEDs in the past five years, 36% of new directors were female. Given the historic stock, the proportion of all NEDs that were female at the end of 2020 was 24%, and of executives was 26%. This compares to 17% and 12% respectively in 2016, showing both the positive direction of change, but also the period taken to deliver it.

In addition, of 198 board directors in our sample at the end of 2020, just one individual considered that they were either disabled or suffering from a long-standing impairment- though we recognise this relies on self-reporting and is likely to be understated. On ethnicity, 8% of the executive teams in the sample were BAME, although more than three-quarters of boards had no executives of BAME representation. Having shared these results with members, we recognise it is both an issue where more work is needed, but also, as described above, an area that requires clarity from FCA, on the nature of balance that it expects and that it believes is achievable and reasonable.

We have also been monitoring the gender pay gap amongst all employees for our members since 2018. None of our members are sufficiently large to meet legislative requirements to publish this data, and again we find that whilst it is useful for internal benchmarking, in small organisations in particular, the data is difficult to interpret, and often severely impacted by individual changes in personnel.

We conclude that on the one hand, more action is needed by our members, but also that raw aggregate data is now always meaningful, and regulators should avoid the temptation to critically comment on data collected, if they don't have a rounded picture and context to support it.

There is of course a growing focus on diversity and inclusion in financial services, from government, regulators and consumers, as well as from within firms themselves. In 2020, we concluded that whilst there were many good initiatives in place, none captured the nature by which mutual organisations express and approach diversity.

As a result, earlier this year we and a number of our members launched the Mutual Diversity Alliance. This is intended to support our members and other associated organisations, in demonstrating their commitment to diversity and inclusion, and the focus is on shared learning and the dissemination of good practice. Whilst members of the Alliance will produce an annual disclosure, beginning in 2022, the focus in on the journey they are taking rather than hard targets.

Mutual Diversity Alliance

committed to inclusivity

Mutual Diversity Alliance

As a member of the Mutual Diversity Alliance, we are committed to maintaining a culture in our organisation that allows all our employees to thrive, and which avoids barriers to our customers, partners and suppliers effectively engaging with us.

Our business should be accessible to everyone, and we are committed to demonstrating inclusive behaviours, and to embracing diversity in all its forms[1]. We recognise the business benefits of having a truly diverse workforce, that is representative of the wide diversity of our membership.

In order to do this, members of the Mutual Diversity Alliance adopt the following good practices:

- Appointing a senior leader in the organisation to lead our work on mutual diversity across the business;
- Treating all customers and employees with respect, dignity and courtesy;
- Making reasonable adjustments to, and maintaining, an appropriate working environment, where employees from diverse backgrounds enjoy an equality of opportunity, and to demonstrate this through equality of pay, the capacity for agile working, fair recruitment and other HR policies;
- Maintaining an effective culture via our Board, that promotes diversity and sets the right example;
- Working with other members of the Alliance to support problem solving, to sponsor training of our people on inclusivity and diversity, as well as on conscious inclusion, and to share good practice, as necessary;
- Reporting each year in September on how we have met the expectations of the alliance.

[1] This is likely to include via race, religion, gender and gender preferences, age, disability or infirmity, sexual orientation and education. We also seek to promote a culture of diversity in thought, experience and background, and through this, to support social mobility.

As customer-owned organisations, we consider that our approach to diversity should extend to the way we make our members' products and service accessible. Hence, as per the slide above, the components of the Alliance include leadership, policy and practices, culture, continuous learning and disclosure. For more, see: https://www.financialmutuals.org/events-training/mutual-diversity-alliance/

We are also putting forward to the AFM Annual General Meeting on 4 October, a change to AFM's constitution, to attempt to widen the pool of eligible Directors of the trade association. Currently the constitution requires that only CEOs of our member organisations can be appointed as a Director, so the composition of our Board is limited by the pool of available CEOs. For the future, we plan to invite members to nominate other executives, with the express purpose of widening the 'diversity of thinking' in AFM, to better prepare us for the evolving business world we are experiencing.

One further area that we think the regulators should monitor is authorisations. We are not aware that there is any difference in the rates of approval, but it might be a useful indicator. We think it would be helpful if the authorisations teams published more data, including:

- The proportion of authorisation applications for each SMR role, for people with one or more diversity characteristic
- The average time for all authorisations for each SMR role
- The average time for authorisations for each SMR role, for people with one or more diversity characteristic
- The average success rate for all authorisations for each SMR role
- The average success rate for authorisations for each SMR role, for people with one or more diversity characteristic

As PRA and FCA raise the expected standards constantly for new applications, we are aware that firms face a difficult balance in finding the right candidate, and this is particularly true for small mutuals, who have limited budgets, small executive teams, and who are often outcompeted in recruiting new talent by larger organisations. We would like to see more consideration by the regulators on achieving a functioning and diverse board, rather than raising obstacles in recruitment, or querying the value of double-hatting.

Another area for regulators to consider is the advice market: currently financial advice is largely limited to the more affluent, and FCA rules make the sale of products on a non-advised basis more difficult. We would like to see research from regulators on barriers to access to financial services.

Q6: What are your views on our suggestions to approach

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 consider proportionality is critical. Existing rules, based for example on the number of employees, make sense when looking at the characteristics of the workforce.

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

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

The average size of Board amongst AFM members has reduced over the years, from 9.2 in 2016, to 9 today. A typical Board for an AFM member contains 2 executive directors, the Chair and 3.5 other independent directors, and 2.5 others (i.e. not independent).

As we report above, we have seen steady evolution of the gender mix on the board, though the low numbers involved- particularly amongst executives- makes detailed analysis of other aspects of diversity of limited value. For example, the change of one executive could alter the diversity mix, from 50% for example, to 100% or 0%.

We do however see reluctance to change in some cases, and difficulties in agreeing a succession plan and recruitment policy. For example, amongst our members sampled, 15% had no female NED: the same organisations typically saw a higher proportion of long-serving NEDs.

Some AFM members retain a delegate system, whereby branches within the organisation appoints their own delegate to the annual general meeting, and delegates directly appoint the board, based on nominations partly or wholly from within the membership. This makes it much more difficult for the chair or executive to exercise control over who is appointed to the Board. Membership in such organisations may be drawn from a relatively narrow set of demographics, and targeting in these circumstances is not likely to be helpful.

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

As mentioned previously, signatories to the Mutual Diversity Alliance are required to appoint a senior leader with responsibility for taking forward work on diversity. We have found this is a very valuable step in taking issues seriously, and in facilitating action across the business.

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?

In mutuals, the focus on variable remuneration is much less than it is in PLC organisations and regulators: for example, in 2020, half of CEOs sampled had no variable pay/ bonuses, and the proportion of total remuneration for all CEOs that was fixed was 92%.

In these circumstances, there is clearly less scope to use the structure of bonuses to alter the approach to diversity, and unless there was a statutory requirement, we do not think it would be practical to amend employment contracts relating to base pay.

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 consider that it is appropriate for financial firms to publish their policy. The AFM Code includes an expectation that a board has a policy on board diversity, whilst the Mutual Diversity Alliance sets out a route by which firms should adapt the HR policies, recruitment, working arrangements and pay, to accommodate its approach to diversity.

We do not assume these approaches should be mandatory, as we rely on the dissemination of good practice to support change. That said, the development of an appropriate culture starts with the leadership of a business, and we consider there is scope for greater direction at a board level.

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 are unconvinced that universal target setting is appropriate, particularly for smaller companies. We note that FCA's separate consultation indicates targeting for the boards of listed companies is likely to become a requirement, and that approach offers an opportunity for in scope firms to adopt targets through the rest of the business.

For unlisted, smaller companies, we think firms should be encouraged to explore for themselves whether and how to establish targets. However, as our earlier analysis indicates, changes take time, and for non-board roles in particular, the low levels of turnover often seen in management roles may indicate change can only happen slowly. Small firms do not have the capacity to create new roles to help meet targets, so meaningful measures might be difficult to warrant in organisations with fewer than 1,000 employees.

Q17: What kinds of training do you think would be effective in promoting diverse workforces and inclusive cultures?

Q18: What kinds of training do you think would be effective for helping understanding of the diverse needs of customers?

We consider regular refresher training on a range of culture-based issues is important for all organisations. For AFM members, who are small and dispersed, this is best delivered online, and the majority of our member organisations subscribe to our online training portal, which includes a range of modules focused on diversity and inclusion.

As highlighted previously, the Mutual Diversity Alliance is devoted to the provision of training and the sharing of good practice, and regular sessions are provided to support subscribers.

As part of the commitment to training on diversity, we would encourage sharing the voices/stories (particularly through videos) of the experiences and perspectives of people with different identities.

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

We are not aware of any research on this and how practical it is, but as the revised product governance requirements in CP21/13 are not yet in force, it may take some time to build the data needed to explore the issue further. In the meantime, we would appreciate any relevant research from the regulators on this issue.

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?

Initiatives like gender pay gap reporting are already mandated, at a level of 250 or more employees. Whilst we have collected data for smaller organisation, on a voluntary basis, we don't find that this is particularly illuminating. For an organisation of, say, 50 employees, gender pay gap reporting is highly skewed by individuals within an organisation, and there is a risk that individuals would be likely to be readily identifiable.

That is even more the case with other measures of diversity, where the numbers of individuals affected is likely to be smaller.

We do see some scope for the regulators to collect limited data from organisations, as part of their supervisory assessment. We think this would be helpful in informing supervisors on the policies adopted and the culture of the organisation, and in assessing whether products and services are being designed with a clear target market in place. We consider that a sample exercise would prove how readily firms can provide this data. We are sceptical however about the value of PRA and/ or FCA publishing this data in the short-term.

Q23: What are your views on how we should achieve effective auditing of diversity and inclusion?

Q24: How can internal audit best assist firms to measure and monitor diversity and inclusion?

Many small mutuals outsource internal audit: this has the advantage of sharing good practice and providing benchmarks that will help organisations, for example in relation to diversity and inclusion.

However, outsourcing also carries significant costs, and when the costs of both internal and external audit have risen sharply in recent years, it would not be helpful to load extra costs onto policyholders.

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

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?

As highlighted above, we consider regulatory authorisations is a prime area for collecting and analysing data on diversity and inclusion, and we would want to understand better how the regulators' approach can accommodate further analysis, albeit not at the cost of further delays in approvals (which already regularly fall below service standards).

We support an approach by the regulators which seeks to understand how an appointment will contribute to the overall diversity within the firm's leadership body. Consideration of the group dynamic, in parallel with the assessment of the individual, would be a helpful step. Knowing that this would be a regulatory consideration at SMF approval stage might also influence the behaviour of recruiters.

Q27: What are your views on providing guidance on how diversity and inclusion relates to the Threshold Conditions?

We would encourage the development of guidance. If PRA and FCA plan to form a practitioner group to inform their views, we urge them to take proper and full account of the needs of smaller businesses.

Q28: Do you have any suggestions on which aspects of our supervisory engagement with firms that you think could be improved to help deliver and support greater diversity and inclusion?

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?

We consider PRA and FCA could support greater diversity and inclusion by ensuring there is diversity within the interview panels when they conduct SMF interviews. They could also look at the areas questioned in these interviews to focus more on values and ethics, rather than predominantly knowledge or direct experience- which would be gained quickly anyway once the candidate is in role.

We think it is right for the regulators to focus on what the benefits are to consumers of this work. We have not seen any published material that helpfully demonstrates the impact of guidance and measurement in this area. However, we strongly believe that a market which maintains or perpetuates any aspect of discrimination is likely to operate unfairly and inefficiently.

Mutual organisations have, for over 100 years, helped to deliver services to all people, and to serve the underserved. That commitment remains constant, so we welcome the opportunity to work with the regulators to understand how the financial sector can remove obstacles and better support the needs of all consumers.