

# D&I regulation update

## FCA and PRA consultation papers on Diversity and Inclusion

**On 25 September 2023, the Financial Conduct Authority ('FCA') published Consultation Paper 23/20, "Diversity and inclusion in the financial sector - working together to drive change", and the Prudential Regulation Authority ('PRA') published Consultation Paper 18/23, "Diversity and inclusion in PRA-regulated firms". Following their joint Discussion Paper ('DP') in July 2021, these Consultation Papers ('CP(s)') set out proposals to introduce a new regulatory framework on Diversity and Inclusion ('D&I') in the financial sector.** 29 September 2023

### At a glance

#### What is it?

The FCA and PRA have published two CPs with proposals for a new regulatory framework on D&I in the sector. These two CPs are broadly consistent in content and set out proposed requirements (subject to proportionality) that firms:

- Embed non-financial misconduct considerations into existing regulatory frameworks;
- Clarify D&I governance of and accountability, including through embedding D&I into existing Senior Management Function ('SMF') responsibilities, certain SMF remuneration, and the role of for risk management and control functions;
- Set a robust and data and evidence driven D&I strategy;
- Set D&I targets to embed this strategy; and
- Introduce new annual D&I monitoring, regulatory reporting, and public disclosure.

#### Who is this relevant to?

All firms authorised by the FCA to carry out a FSMA regulated activity are in scope of at least some of the FCA proposals. CRR and Solvency II firms are in scope of the PRA proposals. The PRA also states that most rules would apply to third country branches of CRR and Solvency II firms (in reference to their UK operations). Both also clarify that the rules would apply to employees that predominantly carry out activities from an establishment in the UK. The definition of employee includes individuals who are employed or appointed in connection with the firm's business, or under a third party arrangement. This means that contractors, secondees and non-executive Board members are likely to be included.

Both the FCA and PRA include provisions to allow for the application of the principle proportionality. Under this principle, the FCA excludes Limited Scope Senior Manager and Certification Regime ('SM&CR') firms from all requirements except those related to non-financial misconduct. Outside of this, proportionality is applied based on organisational size. Those organisations with an average of 251+ employees per entity over a rolling three year period are defined as 'larger firms' and so would be subject to all requirements, while those beneath these thresholds would not have to apply the proposed requirements related to target setting and data monitoring, reporting and disclosure (although voluntary compliance is encouraged).

#### Where can I find them?

The CP published by the FCA can be found [here](#) and the CP published by the PRA can be found [here](#).

#### What is the timing of the changes?

The FCA and PRA will each publish their final rules and guidance as part of a Policy Statement ('PS') in 2024. They propose to bring the rules into force 12 months from publication of these. Reporting and disclosure requirements would be on a 'comply or explain' basis for the first year only.

#### What should I do next?

- Review your current D&I practices to identify any gaps dependant on which requirements are likely to apply;
- Engage with key stakeholders such as the Board, HR, risk and senior leaders to discuss any gaps and agree strategic priorities;
- Consider starting work on any gaps that may take time to address (such as collecting diversity data); and
- Consider whether to respond to the CP by the deadline of 18 December 2023.

#### Who can I contact to discuss this further?

Please get in touch with your usual PwC contact, or one of the individuals listed on page 4.



## **In detail**

### **Embedding non-financial misconduct consideration into frameworks**

#### **Overview:**

Both the FCA and PRA have proposed changes which would result in rules explicitly preventing non-financial misconduct, such as bullying, harassment and discriminatory practices, being embedded into existing regulatory requirements. The intention is that updates to existing misconduct rules will provide clarification to firms on the regulators' approach in this area.

The FCA has proposed:

- Extending the scope of the Conduct Rules to cover serious instances of bullying, harassment and similar behaviour in the workplace;
- Explicitly confirming that bullying, harassment and similar misconduct (both in the workplace and personal life) are relevant to 'fit and proper' requirements;
- Additional guidance on how non-financial misconduct should be incorporated into regulatory references; and
- Expansion of Suitability Threshold Conditions to include discriminatory practice, to be applied in line with existing guidance.

In line with the FCA proposals, the PRA has proposed updates to its supervisory statements for banks and insurers to explain that 'Fit and Proper' assessments may take into consideration established patterns of behaviour such as bullying, harassment and discrimination.

#### **Potential implications for firms:**

While, for many, the proposed changes may formalise existing practices and expectations, firms will need to review current processes and demonstrate that they have taken sufficient steps to embed the proposed new rules (for example through adjustments to annual compliance training). This will likely include reviews of misconduct reporting and 'speak up' processes to ensure that they are sufficiently robust and operate in a culture where these are used in practice. Firms may also need to revisit how existing HR processes (e.g. disciplinary processes) are connected to these in order to ensure that relevant issues are identified.

A specific challenge in doing this will be agreeing a clear and consistent definition of non-financial conduct that can be applied within existing processes and policies. While the regulators do give examples of behaviours and actions that would meet this definition, by nature these examples are not exhaustive. Firms will also need to develop an approach to determine where misconduct meets the threshold of "serious". This will likely be a complex and sensitive area for firms where considerable consideration and consultation will be required.

Under the proposed changes, firms would also, in some cases, have to consider serious non-financial misconduct in relation to SMFs and certified staff's private life. The practical challenges of doing this, as well as potential data protection implications, will need to be carefully considered by firms. Organisations may also wish to consider how they may deal with historical matters which would fall under new proposed definitions of misconduct.

Potential employment law implications should also be assessed. For example, firms will need to be aware of any potential findings against them and their employees and the significance of these in a regulatory context. This may have implications for their approach to Tribunal claims. Employment law advice will be key in managing strategy and mitigating future legal risk.

### **Governance and accountability**

#### **Governance and collective requirements**

##### **Overview:**

Both the FCA and the PRA propose that the Board (or equivalent) have ultimate accountability for D&I, including setting and reviewing the D&I strategy and targets required within the proposals.

The PRA rules also specifically propose that the Board should have an explicit collective responsibility for D&I and adequate time to contribute to the D&I strategy. There is also an expectation that the Board will be able to explain the rationale behind required D&I targets.

#### **Potential implications for firms:**

Whilst, at many firms, the Board will already provide ultimate sign off for the D&I strategy, these proposals formalise that this should be the case in all firms. The implication is that simply reviewing and approving a D&I strategy is unlikely to satisfy this requirement. Instead, the Board and senior leadership will have to take an active role in defining the D&I strategy and associated objectives, goals and targets and reviewing data. This strategy will need to be evidence based and informed by D&I data and reporting (see later sections). As these requirements would apply on an entity by entity basis, firms will also need to consider which Board(s) discharge the requirements in respect of different entities and how this sits within existing governance models.

To demonstrate that the proposed requirements have been embedded, firms may need to update existing governance processes and documentation, including Board effectiveness and succession planning policies, Terms of Reference, standing agendas and reporting and monitoring processes.

#### **Individual accountability requirements**

##### **Overview:**

For those firms in scope of the Prescribed Responsibilities ('PRs') for culture, the PRA proposes to clarify responsibility for the development and implementation of D&I strategies. Under the proposed amendments, SMFs holding the PRs for culture (PR I, typically held by the Chair, and PR H, typically held by the CEO) would be expected to have their responsibilities for D&I reflected in their Statements of Responsibilities (SoRs) as follows:

- The SMF holding PR I would be responsible for ensuring the Board sets, approves, and adopts an appropriate D&I strategy.
- The SMF holding PR H would be responsible for ensuring that the strategy set by the Board is implemented across the firm.

Where firms are not in scope of the culture PRs, at least one SMF should have responsibility for the implementation of the firm's D&I strategy reflected in their SoR.



The PRA has also proposed that the performance objectives and remuneration outcomes of the SMF responsible for D&I strategy (PR H or otherwise) reflect this responsibility, including via the risk adjustment process (where applicable)

**Potential implications for firms:**

Firms will need to update their SoRs as appropriate. Those not in scope of the PRs for culture will also need to identify which SMF will be responsible for D&I. Consideration should be given to any knock on implications of this, for example to employment contracts. On remuneration, firms will need to consider how D&I can best be embedded and how metrics are calibrated, particularly where D&I targets do not align to annual cycles.

**Risk management requirements**

**Overview:**

Both CPs emphasise that D&I should be considered a non-financial risk and treated as such in existing risk management processes. Risk and control functions will play a role in managing these risks and ensuring effective compliance. However, neither CP is specific on how this should be done.

**Potential implications for firms:**

Firms will need to ensure that they have defined the risk(s) associated with D&I and incorporated these in existing processes and governance. For example, risk and compliance functions may wish to incorporate D&I into their oversight of first line activities, whilst internal audit may consider D&I within their risk assessments and as part of their audit plan.

**D&I strategy**

**Overview:**

Both the FCA and PRA have proposed a requirement to develop and publish a D&I strategy (with the PRA also requiring a Board strategy). Whilst the CPs are not prescriptive on this, they do detail specific areas that they would expect it to cover (with some specific requirements from the FCA) including an overview of the firm's core values and culture, clear objectives and goals on D&I, an action plan to meet these, an approach to monitoring progress and the role of all staff in doing this. In line with the broader consultation, there is a significant emphasis on data and evidence based approaches to the development of D&I strategies and action planning.

Firms would need to be able to demonstrate a clear link between the data they are reporting to the regulators, their D&I targets, action plan and broader public strategy. The Board and responsible SMFs would be expected to be able to clearly articulate this.

The PRA notes that the complexity of this strategy may vary proportionately for smaller firms and that practical variations in approach may be appropriate for third country branches where an international group level strategy is in place.

**Potential implications for firms:**

Many medium and larger firms will already have a D&I strategy in place. However, the regulators' review of current approaches to D&I (which informed these CPs) found several shortcomings with existing strategies. It is therefore likely that many firms' current strategies would not fully meet the expectations set out in the CPs. In our experience, this gap is most likely in the explicit connection of a high level strategy to a data driven action plan, underpinned by metrics that are regularly reported to the Board. Governance is also a common gap.

Firms will therefore need to review any existing D&I strategy to ensure it aligns with the proposed requirements. Given the emphasis on taking a data driven approach, firms may also need to undertake a more robust strategy development process, both in terms of the data used (including inclusion data) and stakeholders involved.

**D&I targets**

**Overview:**

Both CPs propose that larger firms (251+ employees) must set demographic diversity targets (and encourage other targets, eg on inclusion). Whilst both regulators provide flexibility in the design and calibration of targets, they specify that individual targets should cover the Board, senior leadership and all employees. Targets would need to be over a set timeline (unspecified) and regularly (biannually under PRA rules) reviewed. The PRA has also stated that targets should be set for women and ethnicity at a minimum. Targets, the rationale for setting them and progress against them would need to be publicly disclosed and reported to the regulator annually.

Both regulators have emphasised the importance of the way targets are set in order to avoid 'tick box' compliance. Firms (and the responsible SMFs) would need to be able to articulate how and why a target was set and its context in the firm's current diversity metrics and strategy and local population demographics.

**Potential implications for firms:**

Many larger firms will have at least some D&I targets (for example through the Women in Finance Charter). However, it is unlikely that most will have targets to meet all of the populations required, particularly on an entity basis, and so at least some revisions will be required.

In our experience, many firms' existing targets may not meet this new guidance. In particular, it may be hard for some to demonstrate that targets specifically relate back to current D&I data as well as the wider strategy and action plan. Firms should review current targets against these criteria to ensure that they (and the appropriate SMF) are comfortable that the rationale and action plan achieving the targets is sufficiently robust. Processes for setting new targets should also be established in line with the proposed rules. Larger firms may also wish to consider if additional voluntary targets (including on inclusion) are appropriate.

Our recommended target setting methodology takes a "bottom up" approach in which analysis of workflow data is used to better understand the experience of underrepresented groups throughout the employee lifecycle. By examining year-on-year data on the rates at which different populations enter, progress, and leave, differences in experiences can be identified and underlying inequalities and barriers identified. Scenarios can then be built to project future employee demographics in order to set evidence led targets that are stretching, but achievable.

For firms in scope of the PRA rules without attributable ethnicity data, this will be an immediate priority (see next section). While the rules apply for the UK only, global firms may also wish to take their footprint into account when defining targets and strategy. Non-UK headquartered firms should also consider how senior leadership targets will apply. Some may wish to seek legal guidance, particularly if they are headquartered in territories where target setting has been challenged.



## D&I monitoring, reporting and disclosures

### Overview:

The CPs include significant additional requirements on D&I monitoring, regulatory reporting and disclosure. Under the proposals, firms would be required to annually collect, report and disclose a range of D&I metrics on an entity level. This includes data on sex or gender, ethnicity, disability, sexuality and faith, with voluntary disclosure on areas such as social mobility encouraged (and with potential to later become mandatory). Firms would also be required to annually ask employees six specific inclusion questions and publish responses. Data would be reported by entity for the Board, senior leadership and all employees. Draft templates for reporting are included as a single PRA/FCA submission.

While the regulators acknowledge that diversity data may be incomplete, they also note that low response rates may indicate a cultural or inclusion issue that needs to be addressed. First year reporting will be on a comply or explain basis, allowing time to update and implement data collection processes. Reflecting the wider regulation, there is a clear expectation that data monitoring will feed into D&I strategy and targets, as well as governance processes.

### Potential implications for firms:

For many, these proposals will go far beyond current processes and all firms will have some gaps (e.g. on new inclusion requirements). While larger firms already collecting diversity data may need to make some adjustments, for those not collecting this data there will be significant work to do as a priority. This will include legal analysis to ensure appropriate privacy documentation is developed and system and/or process updates to create a mechanism for collecting and storing this data appropriately.

Employee communications will be critical to ensuring adequate response rates. Establishing and collecting data with good response rates will often take at least 12 months and therefore work should begin on planning for this immediately.

While inclusion data is likely to be less complex to collect, there are risks to consider. Responses to questions such as 'I have been subject to treatment... that has made me feel insulted... based on my personal characteristics' may be highly sensitive and (on an entity basis) highlight differences within an organisation's culture as well as compared to competitors. An inadvertent legal risk could also be triggered. The quicker firms can begin to collect this data, the quicker they will be able to assess their current state and understand and address potential risks.

From a disclosure perspective, the requirements will add considerable additional information. Organisations should consider how this interacts with other local and global disclosures (e.g. as part of ESG and gender pay gap reporting) to create a clear and consistent narrative. Global firms will also need to consider how disclosure and data collection approaches align with global priorities and sensitivities/legal restrictions.

### Policy areas not covered

A number of policy areas discussed within the DP have not been explicitly carried forward into the CPs. These include:

- Board recruitment, succession planning and talent pipelines;
- Mandatory D&I staff training (although training may still form part of embedding certain requirements);
- Products and services; and
- Mandatory internal audits (although these may still occur to meet risk and control requirements).

### Next steps

The proposed requirements set out within the CPs are wide reaching and few, if any, firms will be fully compliant now. For those firms with mature existing approaches to D&I, meeting the requirements may only necessitate minor changes to existing frameworks. However, they may particularly wish to review and test outcomes under the inclusion questions to understand potential risks and gaps. For all firms, work will also be needed to review the implications of the proposed changes to the rules on accountability and non-financial conduct, and to ensure stakeholders are appropriately aware of and comfortable with their responsibilities and expectations.

For smaller firms and those with less mature approaches to D&I, we anticipate that there will be more considerable work to do. This may include either completely restructuring or the development and implementation of a new D&I framework. A priority within this will be ensuring that the D&I data that should underpin this is available and collected, which may take some time to implement.

A first step for all firms will be to undertake a gap analysis to identify current areas for improvement and development and also potential risk areas (including from a reputational and legal perspective). This can form the basis of any contingency and implementation planning.

A particular priority will be requirements for D&I monitoring, reporting and disclosure, which for many firms will necessitate the collection of additional D&I demographic data. In particular, the development of new data collection processes and the collection itself can involve multi-year implementation timelines and so work on this should not be delayed.

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