EBA criticizes firms in Benchmarking Report on Diversity Practices – what now?

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Since the 2008 global financial crisis, a number of regulatory policymakers and supervisors have used legislative and non-legislative means to push financial services firms as well as listed companies to improve their corporate governance arrangements and promote diversity and inclusion. Diversity in this context is not limited to gender but also includes age, professional and educational backgrounds and origin of members.

Policymakers and many firms that were consulted on the policy proposals committed themselves to creating more diverse management bodies (boards) and, in certain jurisdictions, executive functions (C-Suite), along with gender equality on pay. This built on a consensus that such changes would improve debate, decision making on risk management, and strategic steering by reflecting a broader set of views, opinions, experiences, perceptions, values and backgrounds in the members but also the stakeholders these firms serve, and in addition would boost profitability – the latter being quantifiable in terms of data.

Post-crisis reforms to European Union (**EU**)-wide banking sector legislation (the **CRR/CRD IV Regime**) put these principles into law and slowly this is translating into an emerging supervisory priority, including at the European Central Bank (**ECB**) in its role as the super-supervisor (**SSM**) in the EU's Banking Union, currently comprised of the 19 EU Member States that use the euro. The CRR/CRD IV Regime's requirements also tasked the European Banking Authority (**EBA**)[1] with periodically reporting on how firms across the EU-27 were faring in meeting these requirements on diversity and other policies.

On February 3, 2020, the EBA published its Benchmarking Report on Diversity Practices at the European Union Level based on September 2018 data[2] (the **2020 Report**), which follows an earlier report dated July 8, 2016[3]. The results are telling and this Client Alert assesses the key points banking and other financial and non-financial services firms in the EU and elsewhere will want to consider. The alert concludes with an overview of the outlook ahead and possible strategies to improve compliance, bearing in mind that the EBA, whose supervisory remit in this area is set to expand, has called for supervisors and EU Member States to take action to do more. Equally, the ECB-SSM has, in its 2020 Supervisory Priorities, expressed its concerns over governance standards and strategic steering in the ca. 120 banking groups it directly supervises (**SCI**s) and the ca. 5,000 legal entities it indirectly supervises (**LSI**s). That number of firms, and possibly concerns, is set to grow as the ECB-SSM's supervisory remit expands over the next couple of years. This expansion is being driven by new firms setting up in the Banking Union, but will also rise as Bulgaria and Croatia prepare to join the Banking Union as a precursor to Eurozone membership.

The 2020 Benchmarking Report's key findings

Despite the clear requirements set out in the rules, a number of firms have not adopted a diversity policy and not all of those that have adopted a policy have adopted one that promotes gender diversity by setting a target for women. Firms are required to comply with these rules set in Art. 91 of CRD IV and subsequently the supervisory expectations of competent authorities, both at the national level and the EU-level and thus, within the Banking Union, those of the ECB-SSM.

To recap, Article 91 CRD IV references the need for “an adequately broad range of experiences” (Art. 91(1)) within the overall composition of the management body and that the management body “possess adequate collective knowledge, skills and experience to understand the institution’s activities, including the main risks” (Art. 91(7)). Furthermore, “Member States or competent authorities shall require institutions…to put in a place a policy for the purpose of promoting diversity on the management body” (Art. 91(10)), and competent authorities shall collect and provide relevant information to the EBA to allow for benchmarking of diversity practices at the Union level (Art. 91(11)).

In the EBA’s 2016 benchmarking report, it noted that only a limited number of institutions had adopted a diversity policy and it called on institutions to consider additional measures to promote more balanced gender representation (July 8, 2016).

Subsequent to the 2016 report, “Joint ESMA and EBA Guidelines on the assessment of the suitability of members of the management body” were issued to apply to competent authorities across the EU as of June 30, 2018. The Guidelines provided further clarification and direction regarding the EBA’s diversity policy expectations, including that institutions’ diversity policies should address at least: (1) educational and professional background; (2) gender; (3) age; and (4) geographical provenance, particularly for those institutions that are active internationally. Those Joint Guidelines, which set supervisory expectations that apply EU-wide and ought to be read like rules, have since been supplemented, certainly within the Banking Union, by the ECB-SSM’s own Guidelines and supervisory expectations.

Consistent with sound diversity strategy and the principle of good governance practice as an effective means to advance diversity objectives, the Guidelines specifically set out an expectation that institutions’ diversity policies would include quantitative targets for gender representation, a timeframe within which to meet the targets set and a methodology by which to achieve the specified targets. (Guidelines, Title V, 12.105)

In the 2020 Report, the EBA reiterated and updated the rationale behind the need for robust diversity practices and governance within regulated institutions:

> “The existence of different perspectives can help to improve decision making, as a more diverse management body reduces the phenomena of ‘group think’ and ‘herd behavior’. Diversity can thus help members of the management body to act more efficiently, to achieve a business and risk strategy that is in the best interests of the institution and to ensure sound management of the institution and its staff, including ensuring that the institution’s policies are gender neutral and ensuring equal opportunities for all genders.” (2020 Report, Section 2: Background, page 7, para 3)

The benefits of diverse perspectives are well understood and have been increasingly heralded as critical to prudent risk management and an important contributor to a robust and effective culture of compliance within the financial services sector across the globe. It is also increasingly seen as vital to the industry’s long-term economic health and sustainability.

> “Industry homogeneity in backgrounds, education, gender, and racial/ethnic composition remains prevalent and can foster groupthink cultures. Such environments limit the number of challenges or alternative opinions required to effectively mitigate poor business decisions.
>
> Diversity in thinking, problem solving, and leadership styles helps organizations achieve better results through greater questioning, challenging, creativity, and innovation.”
>
> Diversity delivers to the bottom line.
>
> Getting culture and conduct right is not a supervisory requirement. It is necessary for banks’ and banking’s economic

and social sustainability."

(G30 Report – Banking Conduct and Culture: A Permanent Mindset Change – November 2018)

Despite the growing recognition of the importance of diversity as a prudent risk measure, and the provisions of the CRD IV and the direction given in the Guidelines, in the 2020 Report the EBA noted that "a significant proportion of institutions (41.61%) still have not adopted a diversity policy", that not all institutions with a policy had set gender targets, and that institutions that were still without diversity policies included an "alarming" number of significant institutions (page 11).

The EBA also referenced Article 157 of the Treaty on the Functioning of the European Union in the 2020 Report, stating (emphasis in bold):

> "…equality and equal opportunities for both genders are important values of today's society that are enshrined in Article 157…Disregarding those principles is not only an issue of non-compliance with regulatory requirements but also detrimental to an institution's reputation. **Competent authorities should follow up on cases of non-compliance identified, starting with significant institutions**." (page 12)

For "significant institutions" the EBA specified that they should have in place a nomination committee and gender targets in addition to a diversity policy (page 5 & page 9, para 10). Looking at this in the context of Banking Union and SSM supervision, it is important to note that not all firms that qualify as "significant institutions" for CRR/CRD IV purposes are automatically SCIs for SSM purposes – instead a LSI for SSM purposes may also qualify as a "significant institution" for CRR/CRD IV purposes. This raises some interesting questions as to how and indeed which authority within the Banking Union will take the lead in respect of which firms. This is the case even if the expectation is that the ECB-SSM – given that improving governance standards has been a SSM supervisory priority since the Banking Union's creation in 2014 – will likely be influential in shaping supervisory policy and where and how frequently compliance with expectations are monitored.

The 2020 Report and its admonitions to the industry must be taken seriously. It is apparent that ongoing non-compliance will no longer be tolerated, particularly as the trend toward greater diversity as an integral component to a robust culture of compliance continues.

Outlook

As we move towards a more stringent enforcement period, it will be interesting to see how the EBA (and national competent authorities across the EU-27 and the ECB-SSM in respect of the Banking Union) will assess and evaluate compliance with not only the requirement for written diversity policies and associated governance policies and practices, but also institutional adherence to and the effectiveness of those policies and practices.

This is equally the case as the ECB-SSM has, as part of its 2020 Supervisory Priorities and the forthcoming supervisory cycles of SCIs but also to some degree for LSIs, committed itself to use various desk-based and on-site inspection tools to assess firms' compliance and efficacy of governance. Decision making and diversity and inclusion are likely to be factored into those assessments. Other supervisory authorities in the EU and elsewhere, acting within their respective institutional and legal mandates, may indeed decide to follow suit.

Execution and implementation of an effective diversity strategy is complex and demands the coming together of expertise from across multiple disciplines, as well as a new understanding and appreciation of the intersection between regulatory law, corporate governance, and compliance practices on the one hand, and diversity and inclusion as a specialized discipline on the other. Consequently, firms will want to take note of the 2020 Report and take action, in particular as competition for core staff and new candidates may heat up, while at the same time they are faced with much more supervisory scrutiny.

Non-action is likely to be challenged by supervisors and possibly other private sector stakeholders. Firms, supported by regulatory compliance and governance counsel who are conversant in diversity and inclusion best practices, may wish to consider setting up a taskforce to assess the current state of compliance and to identify avenues to advance change and enhance compliance through effective governance practices and human capital initiatives.

If you would like to discuss strategic options or any of the items mentioned above, in particular how to plan ahead for any operational impact from meeting compliance requirements and/or documentation, including client-facing or transaction-related agreements or disclosures, or more generally how these priorities may affect your business or your clients more generally, please speak to our key contacts.

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1. The main task of the EBA is to contribute, through the adoption of binding technical standards and guidelines, to the creation of the European "Single Rulebook" in banking. The EBA is also tasked with promoting convergence of supervisory practices to ensure a harmonized application of prudential rules. Moreover, the EBA is mandated to assess risks and vulnerabilities in the EU banking sector through, in particular, regular risk assessment reports and EU-wide stress tests, as well as to act as investigator of incorrect/insufficient application of EU law by national competent authorities in the EU, and to mediate in the events of disputes between NCAs, as well as to act as an independent advisory body to EU policymakers on financial services rulemaking.↩
2. See here. ↩
3. See here.↩

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