

11 Jan 2019

Dear Sir/Madam,

Hermes Investment Management response to Department of Business, Energy and Industry Strategy Consultation on ethnicity pay reporting.

Hermes Investment Management welcomes the opportunity to provide our comments on this consultation on ethnicity pay reporting.

Hermes Investment Management is an asset manager with a difference. With £30.1 billion in assets under management, we focus on holistic returns – outcomes for our clients that go far beyond the financial – and consider the impact our decisions have on society, the environment and the wider world. Our stewardship team, Hermes EOS, is one of the world's leading engagement resources, advising on £359 billion on behalf of over 40 international institutional investors.

The views expressed in this communication are those of Hermes Investment Management and Hermes EOS and do not necessarily represent the views of all clients. Our response to this consultation is explicitly supported by British Coal Staff Superannuation Scheme (UK), Mineworkers Pension Scheme (UK), PNO Media (the Netherlands), and VicSuper (Australia).

In responding to this consultation, our perspective is informed both by our role as an employer of approximately 400 people, and by our engagement with companies through Hermes EOS, wherein, as a representative of global institutional investors, we seek to promote the creation of long-term, sustainable value for all stakeholders, society and the environment.

We would like to express our strong support for all the arguments made in favour of promoting ethnic diversity and inclusion in the workforce – both economic and moral – and for the recommendations of Baroness McGregor-Smith, which we believe to be based on a thorough and thoughtful investigation.

Although we broadly support her recommendations, on certain specific points (for example, application to all employers with 50+ employees, or reporting against 20,000GBP salary bands), we would favour aligning with the requirements of the gender pay gap reporting to enable better data analysis and comparability, and to simplify the burden on companies. We believe the requirements for ethnicity pay reporting should be at least as rigorous as those for gender pay gap reporting, but acknowledge that the relative complexity of ethnicity may require a different approach in some areas.

We believe ethnicity pay reporting will bring a number of clear benefits, including greater transparency for companies and their stakeholders, including investors; the ability to identify and address barriers, and to benchmark and measure progress; and the establishment of a common language and frame of reference for what is often considered to be a complex and sensitive debate that some are nervous to participate in.

As we have seen with gender pay gap reporting, it will encourage greater board-level oversight and discussion of these issues, dovetailing with the enhanced responsibilities of boards set out in the new UK Corporate Governance Code to promote diverse and engaged workforces. Likewise, it will encourage greater investor engagement on the topic, providing greater transparency and a clear framework for discussions at board and management level.

That businesses in the main have not taken up the Government's request for voluntary action on ethnicity reporting, in part, reflects the complexities and barriers involved, as well as the lack of consensus and clarity on what should be reported and why. This lack of clarity has likely also been a barrier to greater investor engagement on this topic. In our engagement with companies we express the expectation that they demonstrate a commitment to promoting ethnic diversity at board-level and beyond. However, ethnicity pay reporting would greatly enhance our visibility of a company's performance and enable richer discussions.

Learning from our experiences with gender pay gap reporting, providing companies with more guidance on accompanying narratives and action plans would also be helpful. We recognise the risk that requiring companies to produce action plans could result in 'knee jerk' or generic responses. However, we believe the need to crystallise meaningful and effective actions would promote peer-to-peer learning and the dissemination of good practices, as well as enable wider assessment of the impact of different actions over time. We would suggest companies could also be required, perhaps bi-annually, to run an engagement process with employees in which they share their data, proposals and challenges, and seek input. This could help to elevate this from a reporting exercise to a more meaningful opportunity for cultural change.

Collecting and reporting data is essential to bring much-needed transparency to this issue, provide a baseline and monitor progress over time. However, it presents a number of challenges.

While data on gender is usually collected *de facto* as part of the recruitment process, this is not the case for ethnicity and we believe that the majority of employers will hold limited or no data. Where data is collected, classifications and disclosure rates vary, particularly where employees do not understand how their data will be used.

In our view, the following steps would help to address these challenges:

1. **Establishment of clear classifications:** Recognising the limitations of any set of classifications to fully reflect reality, it is nonetheless essential to have an agreed framework to guide data collection and reporting. Given the perceived complexity and sensitivity of the issue, it also helps to provide common vocabulary to frame and enable discussion. The census has established ethnic group classifications that could be used, although there are differing views as to their suitability. Given the importance of these being relevant and fit for purpose, it would be ideal to begin with further consultation to agree these classifications.
2. **Government support and communication:** Alongside support offered by Government to employers (including, for example, guidance, case studies and training) there should be clear communication to employees, via public awareness campaigns, about what is being collected and why. This would help to raise awareness and understanding, and galvanise data collection efforts.
3. **Clear framework and timeframe for employers:** Government should establish a clear framework of reporting requirements, including guidance on supporting narratives and action plans, and allow enough time for employers to make the required changes to their systems and processes to enable data collection and reporting, and to run internal engagement campaigns to promote employee understanding and participation. As such, we would suggest that public reporting should begin no earlier than 2021. This could constitute a key element of company reporting in fulfilment of Section 172.

Further to these general points, we have provided some brief answers to the consultation questions below.

Yours sincerely,

Amy Wilson

Associate Director, Hermes Equity Ownership Services

+44 207 680 4679

amy.wilson@hermes-investment.com

1. What are the main benefits for employers in reporting their ethnicity pay information?

We agree with all the arguments made in favour of promoting more diverse and inclusive workforces, as a driver of performance and in order for businesses to better reflect the communities in which they operate.

Ethnicity pay reporting will provide employers with a greater understanding of their workforce, enable benchmarking and measurement of progress over time. Taking steps to address barriers to ethnic diversity in the workforce will, ultimately, give them access to the widest range of talent, as well as contributing to more inclusive culture and engaged workforce.

2. What type of ethnicity pay information should be reported that would not place undue burdens on business but allow for meaningful action to be taken?

We note that there are a number of challenges to collecting, analysing and reporting sufficiently granular ethnicity pay data, particularly given the need for employees' self-disclosure and the need to protect anonymity. As such, any requirements should balance the burden on companies, the complexities involved and the usefulness of the resulting data.

We believe companies should provide:

- A full breakdown of the ethnicity of their workforce, against an expanded set of classifications (such as the 18 classifications in the 2011 census, plus a 'prefer not to say' option)
- The proportion of employees in different ethnic groups in the lower, lower middle, upper middle and upper quartile pay bands, which would align with gender pay gap and CEO pay ratio reporting requirements.
- Pay gap reporting for an aggregated set of classifications (such as the five classifications in the 2011 census, plus a 'prefer not to say' option). Companies should report further at a sub-category level (such as the 18 classifications) where this represents at least 2% of the workforce or 200 people (whichever is lower).
- The proportion of non-respondents. Should companies struggle to publish adequate data due to employees' unwillingness to disclose ethnicity information, they should set out the steps they are taking to improve employee engagement and disclosure

We would advocate for a reasonable timeframe to allow employers to sufficiently prepare for these reporting requirements (including implementing system and process changes and engaging employees), with the first public reporting in 2021. This would enable leading companies to produce 'dry run' internal reporting, or voluntary early public reporting in 2020.

3. What supporting or contextual data (if any) should be disclosed to help ensure ethnicity reporting provides a true and fair picture?

Again, any requirements should balance the burden on companies, the complexities involved and the usefulness of the resulting data. Companies should publish contextual information on gender, age, and geography and other meaningful indicators, where this is relevant to their data.

4. Should an employer that identifies disparities in their ethnicity pay in their workforce be required to publish an action plan for addressing these disparities?

Yes, along with a narrative that can include explanation of any issues faced (for example, regarding declaration rates). We would suggest guidance and examples of best practice are provided to support this, both for initial reporting and in subsequent years as understanding of what has worked builds.

5. Do you currently collect data on ethnicity at your workplace? If yes, do you use standard ethnicity classifications for reporting? If so, which ones?

We collect ethnicity data for Hermes Investment Management, although this is not yet complete. We use classifications based on the 2011 census.

6. What do you think are the most effective approaches for employers to improve employee self-reporting or declaration rates?

Employers should run engagement campaigns that clearly explain to employees what is being collected and why, and that reassure them about the use and protection of their data. This could be supported by Government-lead communication to employees, via public awareness campaigns, that raise awareness and understanding. Employees should be able to select 'prefer not to say' options, and employers should report the proportion of employees selecting 'prefer not to say' or the proportion of non-respondents.

7. How should self-reporting or non-disclosure rates be reflected in the information reported by employers?

Compulsory publication of self-reporting or non-disclosure rates should be included in the data, with detail of steps the company is taking to address employee engagement and disclosure rates included in the narrative, as relevant.

8. For a consistent approach to ethnicity pay reporting across companies, should a standardised approach to classifications of ethnicity be used? What would be the costs to your organisation?

Yes. The census has established ethnic group classifications that could be used, although there are differing views as to their suitability. Given the importance of these being relevant and fit for purpose, it would be ideal to begin with further consultation to agree these classifications.

We believe that costs to our organisation would be lower than may be the case for others as the system we use can be updated relatively easily to accommodate different classifications. This does not take account of the time/labour resource required to make any changes.

9. Please outline steps that should be taken to preserve confidentiality of individuals.

We support the approach taken by the Civil Service of not reporting data with fewer than five responses to preserve anonymity. In an ideal scenario, our preference would be to raise this to no fewer than 10 responses to ensure individuals are protected. However, we recognise that raising this minimum threshold would potentially significantly impact the amount of reporting from companies given the low representation of minority groups.

10. What size of employer (or employee threshold) should be within scope for mandatory ethnicity pay reporting?

Employers with 250+ employees, to align with gender pay and executive pay reporting (due to come into effect in 2019).

Initially, we agree that requiring organisations with 50+ employees would result in undue burden. However, in due course, we would be open to the threshold for both ethnicity and gender pay reporting being lowered to organisations with 50+ employees, along with review of the definition of 'employee' which may at present exclude certain types of worker from reporting, such as partners in a partnership model.

11. What support measures do you think would be useful for employers?

This should include guidance, training and dissemination of best practice, as well as communication to employees via public awareness campaigns to raise awareness and understanding.