First Sentier Investors

Principal Adverse Impacts Reporting

An Explainer on Gender Diversity

The Sustainable Finance Disclosure Regulation (SFDR) for the European Union mandates the disclosure of the "Principal Adverse Impacts (PAI) that investment decisions have on sustainability factors[1]". These can broadly be thought of as the negative impacts caused by a firm or an asset, on people and planet.

Asset managers are among the "financial market participants" that need to report on mandatory and voluntary PAIs, in order to identify and assess risks and minimise harm associated with their portfolios.

This article focuses on two of the PAIs – **unadjusted pay gap** and **board gender diversity** – and provides details about the measures, some of the challenges related to them, and how investors may use the information they provide.

1 European Securities and Markets Authority https://www.esma.europa.eu/sites/default/files/library/jc_2021_03_joint_esas_final_report_on_rts_under_sfdr.pdf

Gender Pay Gap Reporting

The unadjusted gender pay gap is defined as the 'difference between average gross hourly earnings of male paid employees and of female paid employees as a percentage of average gross hourly earnings of male paid employees'.

Why it's important

This metric can be indicative of a company's levels of commitment to gender diversity, and a large pay gap may point to underlying gender discrimination, or unconscious bias against women, in the organisation. Note that it is unadjusted, meaning that it doesn't compare wages between males and females in the same roles; instead, it compares the total wages for men and women respectively.

As such, if there is a preponderance of males in more senior/better-paid roles, and females in lower-paid roles, this will result in a larger pay gap.

Thus, it can be a useful metric for gauging how well a company is making strides towards diversity at the more senior levels, where a lack/low level of senior management women will feed into a larger pay gap. Conversely, a smaller pay gap suggests that there may be a higher proportion of female employees in senior roles and/or well-paid roles.

This metric can also provide insight into company culture, and whether any of its statements about valuing diversity align with the facts. For example, in the UK, whenever a company listed on the government's gender pay gap service tweets International Women's Day key phrases, a Gender Pay Gap Bot automatically responds with that company's median gender pay gap. This popular bot is designed to "provide a neutral, factual counterpoint to emotion-led International Women's Day social media posts," and can point to a disconnect between companies' words and actions[1].

Issues and Challenges

The use of unadjusted pay gap as a metric is somewhat limited, in that it does not provide 'like for like' comparison between men and women doing the same role. It reflects the composition of the workforce and the prevalence of each gender in lower – or higher-paying roles.

1 https://genderpaygap.app/

There are also no simple solutions to the pay gap. It exists as a societal issue, as well as within individual companies, and reflects cultural issues and work practices. Australia's Workplace Gender Equality Authority (WGEA) explains that "closing the gender pay gap requires cultural change to remove the barriers to the full and equal participation of women in the workforce".

Another complexity is that while the reporting of this data is optional, it is often only companies that are performing well who choose to report on it. This may give a falsely positive impression of overall progress on the issue at a broader level.

There are many factors that contribute to the gender pay gap at a societal level and within organisations. WGEA cites the following as causes[2]:

- conscious and unconscious discrimination and bias in hiring and pay decisions
- women and men working in different industries and different jobs, with female-dominated industries and jobs attracting lower wages
- lack of workplace flexibility to accommodate caring and other responsibilities, especially in senior roles
- high rates of part-time work for women
- women's greater time out of the workforce for caring responsibilities impacting career progression and opportunities
- women's disproportionate share of unpaid caring and domestic work

WGEA also suggests some ways that business can reduce the gender pay gap, including:

- conducting an audit to understand the size of the gender pay gap
- reporting the findings to management and employees
- setting key performance indicators (KPIs) for leadership to reduce the gender pay gap
- taking action to increase the number of women in leadership positions
- encouraging men to access flexible work arrangements and leave entitlements.

The UK Equality Office provides evidence-based recommendations for companies to decrease their pay gap:

- Include multiple women in shortlists for recruitment and promotions
- Use skill-based assessment tasks in recruitment
- Use structured interviews for recruitment and promotions
- Encourage salary negotiation by showing salary ranges
- Introduce transparency to promotion, pay and reward processes
- Appoint diversity managers and/or diversity task forces

It also provides guidance for companies to identify the source of their pay gaps[3], prompting companies to consider if:

- People get 'stuck' at certain levels
- There is a gender imbalance in promotions
- Women are more likely to be recruited into lower paid roles
- Gender differences in staff turnover/retention
- Gender differences in performance scores

Data availability

Reporting requirements vary between markets. In 2017, the UK government introduced world-leading legislation that made it statutory for organisations with 250 or more employees to report annually on their gender pay gap[4]. This is comprised of:

- mean and median gender pay gaps
- mean and median gender bonus gaps
- proportion of men and women who received bonuses
- proportions of male and female employees in each pay quartile

In Australia, companies with 100 or more employees must report their gender pay gap to WGEA. They must also provide details on workforce composition; salaries and remuneration; and employee appointments, promotions, resignations, and parental leave.

Following the passage of the Workplace Gender Equality Amendment (Closing the Gender Pay Gap) Bill 2023 in Federal Parliament in March 2023, Australian employees will be able to access details of their employer's gender pay gaps, from early 2024 onwards.

2 https://www.wgea.gov.au/the-gender-pay-gap
3 https://gender-pay-gap.service.gov.uk/guidance/eight-ways-to-understand-your-organisations-gender-pay-gap/1
4 https://www.gov.uk/government/publications/dhsc-gender-pay-gap-report-and-data-2022/2022-gender-pay-gap-report

In the EU, the Pay Transparency Directive is making gender pay gap reporting compulsory for many employers across Europe. Member states must implement changes by June 2026, employers with 250 or more workers must report their gender pay gaps every year, and employers with 150–249 workers will have to report every three years. The first reports will be published in 2027 and will relate to the 2026 calendar year. The threshold will then be lowered to just 100 workers, and these smaller employers will also have to report gender pay gaps every three years, beginning with reports published in 2031 relating to the 2030 calendar year.

New legislation will also require EU companies to disclose information that makes it easier for employees to compare salaries and expose existing gender pay gaps. The rules stipulate that workers and workers' representatives will have the right to receive clear and complete information on individual and average pay levels, broken down by gender. If pay reporting shows a gender pay gap of at least 5%, employers will have to conduct a joint pay assessment in cooperation with their workers' representatives. Member states will have to put in place effective, proportionate and dissuasive penalties, such as fines, for employers that infringe the rules.

The US does not have any regulatory requirements to report on gender pay gaps. A study from the nonprofit Just Capital, reported in Bloomberg, found that less than a quarter of 954 major U.S. companies disclosed conducting the analysis. Of those that do say they're looking at the numbers, almost half don't release any information about their actual performance on issues of gender pay equity, the group found. Only 75 companies in the research reported the exact pay ratios between women and men[5].

Against this backdrop, it may be difficult to source data on the gender pay gap for most companies. Sustainalytics found that among 11,705 researched entities, only 162 reported on this – or approx. 1%. However, this doesn't mean that financial market participants (FMPs) can avoid reporting on it as a PAI. A Sustainalytics article on the issue points out:

> *"Indicators that have been traditionally included in sustainability reporting, such as board diversity or human rights, have ample data to report. However, issuers still face challenges in reporting on less common metrics.*
>
> *"To address these data shortages, regulation stipulates that FMPs should use 'best effort' strategies to fill gaps, such as resorting to external data providers or experts, or making 'reasonable assumptions.' FMPs will be required to address such gaps in a narrative disclosure, as they cannot exclude investments from PAI calculations due to a lack of data."*[6]

With the change in EU and Australian policy outlined above, it's likely that data will improve in coming years; however, for the time being, investors will need to request this data. A collaborative approach may be useful here, to set expectations among company management and make gender pay gap data collection an expectation.

Investors may also look to resources that report on unadjusted pay gaps at country and industry levels, in order to see a baseline. For example, WGEA provides industry, state and occupation pay gap data.

5 https://www.bloomberg.com/news/articles/2022-03-15/equal-pay-day-most-u-s-companies-aren-t-disclosing-gender-pay-gap-data#xj4y7vzkg
6 https://www.sustainalytics.com/esg-research/resource/investors-esg-blog/filling-in-the-data-gaps-the-current-state-of-reporting-on-principal-adverse-impacts-disclosures-for-the-sfdr

Thresholds

Ideally, we would like to see companies with a zero pay gap. However, given research suggests the average woman earns just 82 cents for every dollar earned by a man[7], there is significant work required to find parity at a global level. Moreover, there are significant differences across regions, industries and job functions. In the US, for example, estimates show that women earn 83 cents for every dollar earned by men (unadjusted)[8]; in Europe that figure is 87 cents[9], and in Australia it is 77 cents[10].

For industry differences, using Australia as an example, we see that the gender pay gap is highest in Construction (29%) and Financial and Insurance Services (28.6%) and smallest in Public Administration and Safety (3.7%).

There are even key gaps between racial/ethnic groups. For example, in the US, research shows white women earn 27% less than white men, but black women earn 36% less and Latinas earn 46% less than white men[11].

Once we see more reporting on this issue, we hope to be in a position to set achievable expectations relevant to the market and industries being covered.

Engagement

When engaging with companies on their gender pay gap, questions to ask include:

- What factors do you believe are contributing to a pay gap in your organisation?
- What policies or initiatives do you have in place to address these issues?
- Have you set targets/timeframes for improvement?

7 https://www.forbes.com/advisor/business/gender-pay-gap-statistics/#general_gender_wage_gap_statistics_section
8 https://www.payscale.com/research-and-insights/gender-pay-gap/
9 https://commission.europa.eu/strategy-and-policy/policies/justice-and-fundamental-rights/gender-equality/equal-pay/gender-pay-gap-situation-eu_en
10 https://www.wgea.gov.au/pay-and-gender/gender-pay-gap-data – this includes bonuses, overtime and additional payments
11 https://leanin.org/equal-pay-data-about-the-gender-pay-gap

Board Gender Diversity

Why is it important?

Diversity of thought and skills are important for companies to achieve their potential and to reduce risk. One measure companies can take to improve diversity of thought is to improve the gender mix of their employees, and specifically those at board and senior management level.

A report by Realindex (a First Sentier Investors brand), titled 'Beyond Lip Service: tracking the impact of the gender diversity gap', is based on a global data set spanning over 2500 large cap companies, in 30 countries, over more than a decade. The findings of the data are clear: more gender diverse leadership teams deliver better performance outcomes.[1]

Research such as 'Diversity wins: How inclusion matters', by McKinsey, has found links between improved gender representation and productivity, collaboration and employee retention.

The UK Financial Reporting Council published a study, Board Diversity and Effectiveness in FT350 Companies, in 2021 that found: "Higher levels of gender diversity of FTSE 350 boards positively correlate with better future financial performance (as measured by EBITDA margin)... Likewise, FTSE 350 boards with well managed gender diversity contribute to higher stock returns, and are less likely to experience shareholder dissent."

As such, it can be argued that a lack of diversity on boards may increase governance risks and undermine the ability to maximise company growth and valuation.

Issues and challenges

Different countries have differing regulations and standards for board composition. In several European markets, board diversity has been mandated for some years. In fact, the Realindex study found that a key driver is the level of pressure applied to companies through disclosure or legislation. Developed markets perform better in gender diversity than their emerging market counterparts. In Europe and North America, the average is above 30%. Australia has not imposed any quotas but has had a focus on gender diversity disclosure and targets through the ASX Corporate Governance Guidelines, which expect a minimum of 30% female board representation.

Just because there is widespread reporting on board diversity, it doesn't necessarily follow that the numbers are satisfactory.

1 https://www.firstsentierinvestors.com.au/au/en/institutional/insights/latest-insights/decoding-the-diversity-premium.html

Increasing gender diversity on boards requires a pipeline of female talent at the management level; however, there has been slow progress on this front. For example, Women on Boards found that women still only make up 9% of positions in the ASX200 that are likely to be preferred as future directors – CEO, CFO or line positions with revenue responsibility – while 44% of men occupy executive positions that boards currently favour as directors.[2]

As demand for female board directors increases, there are also risks of 'overboarding', where a small pool of directors is sought out, leading to them holding multiple appointments. This can reduce the diversity of thought that should be one of the goals of gender diversity.

Data availability

Unlike pay gaps, gender diversity on boards is very widely reported. In fact, 100% of companies analysed by Sustainalytics make this data available. It is also a feature of investor engagement. Proxy adviser Glass Lewis reviewed the 2020 proxy season and found that "lack of sufficient board gender diversity [was] one of the leading drivers for directors who failed to receive majority shareholder support. In part, that reflects what can be measured — by and large, gender is disclosed".[3]

In 2023 we looked at the percentage of females on boards in our listed equity portfolios, to see how far we are from reaching the thresholds set out in the next section. The average for Australia is relatively low for developed markets, but likely due to our exposure to smaller companies, where female representation is lower. For example, there are 97 companies in the ASX300 which fall below the 30% mark.[4]

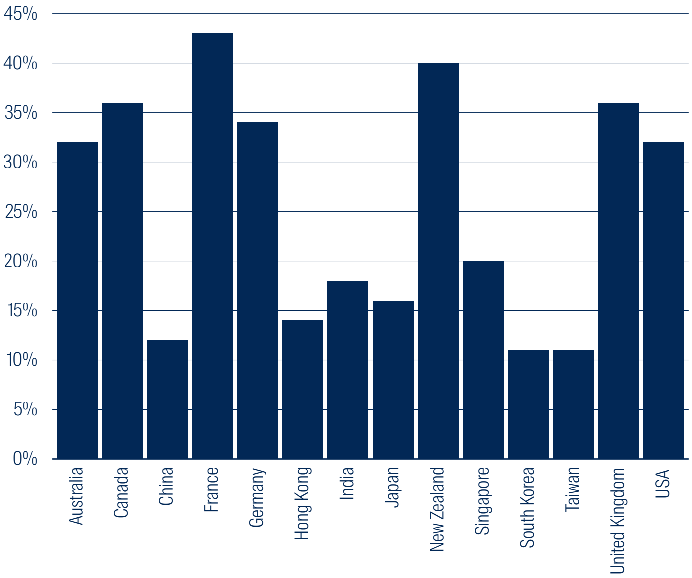
Table 1: Percentage of Females on Boards – FSI Listed Equities Portfolios

Region	Assets under management (AUD)	Wtd. Avg. % Females on Boards
Americas	14,185,162,419	29.5%
Europe, Middle East, Africa	7,160,432,250	25.3%
Australia, News Zealand	37,350,800,134	23.3%
Asia	45,507,296,113	14.6%

Source: First Sentier Investors, Sustainalytics, as at 30/6/2023

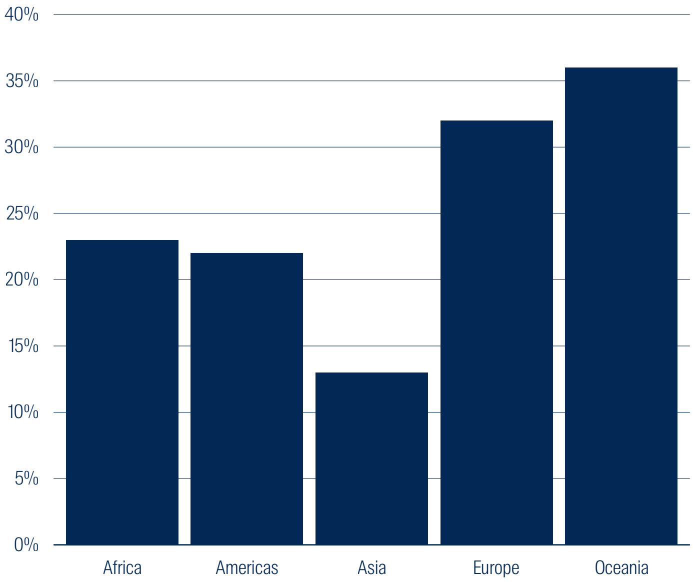
Using Sustainalytics data, we also calculated the country and regional averages for the PAI universe, as outlined below.

Table 2: Percentage of females on board by country – SFDR PAI data set



Source: First Sentier Investors, Sustainalytics, as at 21/9/2023

Table 3: Percentage of females on boards – by region SFDR PAI data set



Source: First Sentier Investors, Sustainalytics, as at 21/9/2023

2 https://www.womenonboards.net/en-au/news/fewer-ex-ceos-appointed-as-boards-increase-diversi
3 https://www.glasslewis.com/wp-content/uploads/2021/04/Race-Ethnicity-in-the-Boardroom.pdf
4 https://www.womenonboards.net/en-au/news/wob-welcomes-acsi-voluntary-target-becoming-mandat

Thresholds

FSI has been an Investor Working Group member of the 30% Club Australia since 2018. The 30% Club is a global campaign with a target of at least 30% representation of all women on all boards and C-suites globally.

The FSI Responsible Investment team recommends that company boards in developed markets should be comprised of at least 30% females, with a stretch target of at least 40%. For small company boards, we expect at least one non-executive director to be female. For Latin America, Asia and the Middle East, we recommend a target of 20% female board members, cognisant of the fact that current levels of gender diversity are lower than developed markets.

Engagement

For companies with poor gender diversity, potential questions to ask include:

- What is the current percentage of women on your board, at executive level, in management and of your total employees?
- Do you have a strategy for improving the representation of women at all/any of these levels? If so, what are your plans and what targets have you set? If not, are you considering putting in place a diversity strategy, and do you have timeframe for when that strategy will be in place?

Given the good availability of data, coupled with clear expectations being set by investor groups such as the 30% Club, investors often use their voting rights to signal to companies the need to take action in this area.

For example, our Realindex investment team follows the Glass Lewis policy to “vote against the nominating committee in instances where the board of a large – or mid-cap company is comprised of fewer than 30% female directors; or vote against the male members of the nominating committee where there is not at least one woman on the board of a small-cap company”.

This is in line with a voting policy recently announced by the Australian Council of Superannuation Investors (ACSI) aimed at promoting gender balance in Australia’s listed company boardrooms. The policy could see those companies facing recommendations ‘against’ male director re-elections if women do not occupy a minimum of 30% of board seats. ACSI and its members are also encouraging companies to develop a timeframe within which they will achieve gender balance (40:40:20) on their boards.[5]

Conclusion

While there is excellent coverage of gender diversity reporting for boards, there is significant room for improvement in the reported levels in most markets. In future, it will also be desirable to see reporting on other types of diversity, such as ethnicity, socio-economic or disability.

For unadjusted gender pay gaps, we expect to see further disclosure from companies over time as regulations evolve. However, until then, asset managers will face challenges in finding publicly disclosed information in most markets. We will need to request this information from companies, and if they do not provide this, use estimates based on industry averages or other proxies.

5 https://acsi.org.au/media-releases/30-women-on-boards-now-minimum-expectation-under-new-acsi-voting-policy-to-boost-director-diversity/

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