Environmental, Social, And Governance:

Diversity And Inclusion As A Social Imperative

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(*Editor's Note:* *This article is the second in a two-part series on racial inequality in the corporate world. The first "Why Corporations' Responses To George Floyd Protests Matter," was published on July 23.)*

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Key Takeaways

- We believe racial inequality, which we cover in our review of the workforce and diversity in our ESG Evaluation where data is available, is becoming increasingly important as stakeholders' concerns mount.
- The recent Black Lives Matter movement has led scores of companies to denounce racism and commit to addressing racial inequality within their organizations by revisiting their diversity and inclusion policies.
- In particular, we foresee inclusion practices as critical to the success of a company's workforce and diversity strategy and therefore to its ESG performance, and potentially also its credit quality if failure to adopt inclusion practices translates into a loss of customers and reduces profitability.

The Black Lives Matter movement has pushed the long-standing issue of systemic racism to the fore. Stakeholders' increased awareness and activism are pushing corporate transparency and accountability to unprecedented levels. As customers, employees, and shareholders are opening their eyes to the reality of what the Black community faces, they are calling on corporates to address discrimination within their organizations. The wave of advocacy for change has prompted many companies to publicly condemn racism and pledge to foster a more diverse and inclusive workforce (see "Why Corporations' Responses To George Floyd Protests Matter," published July 23, 2020, on RatingsDirect).

S&P Global Ratings believes companies that fail to live up to their diversity and inclusion (D&I) commitments could ultimately see a decline in their ESG performance, and potentially their credit quality if this translates into a loss of customers and reduces profitability. Companies are aware that having a diverse value chain--including suppliers, customers, distributors, and revenue streams--is good for business. Yet many are still to achieve a truly diverse workforce. We foresee a widening competitive gap between companies that adopt effective strategies for workforce and diversity, and those that do not. In our view, inclusion is key to getting the strategy right.

Workforce Diversity Matters To Our ESG Evaluation

We believe the limited representation of Black voices in key decision-making processes prevents companies from reaping the benefits of a diverse workforce. It also exposes companies' reputations to allegations of discrimination, as shown by recent calls on social media to boycott certain businesses after apparently racist behavior of employees were captured on video and shared. As such, we believe companies need to be deliberate in how they recruit, hire, and develop Black talent if they want to achieve a sustainable and diverse workforce, thereby improving ESG performance.

As part of our social assessment in the ESG Evaluation, we assess how effective a company is at developing a productive and inclusive workforce. Key indicators include employee retention and turnover rates, labor standards, pay, benefits, and rewards. We also assess whether fair labor standards are entrenched across the value chain. Moreover, we evaluate an entity's preparedness to respond to long-term risks and opportunities, including from changing demographics and social patterns. We assess the extent to which decision-making demonstrates the company's commitment to its long-term strategy and sustainability, as well as its success at building an inclusive workplace culture. These practices are particularly important given the presence of systemic racism, which continues to disadvantage Black people in corporate environments, particularly in the U.S.

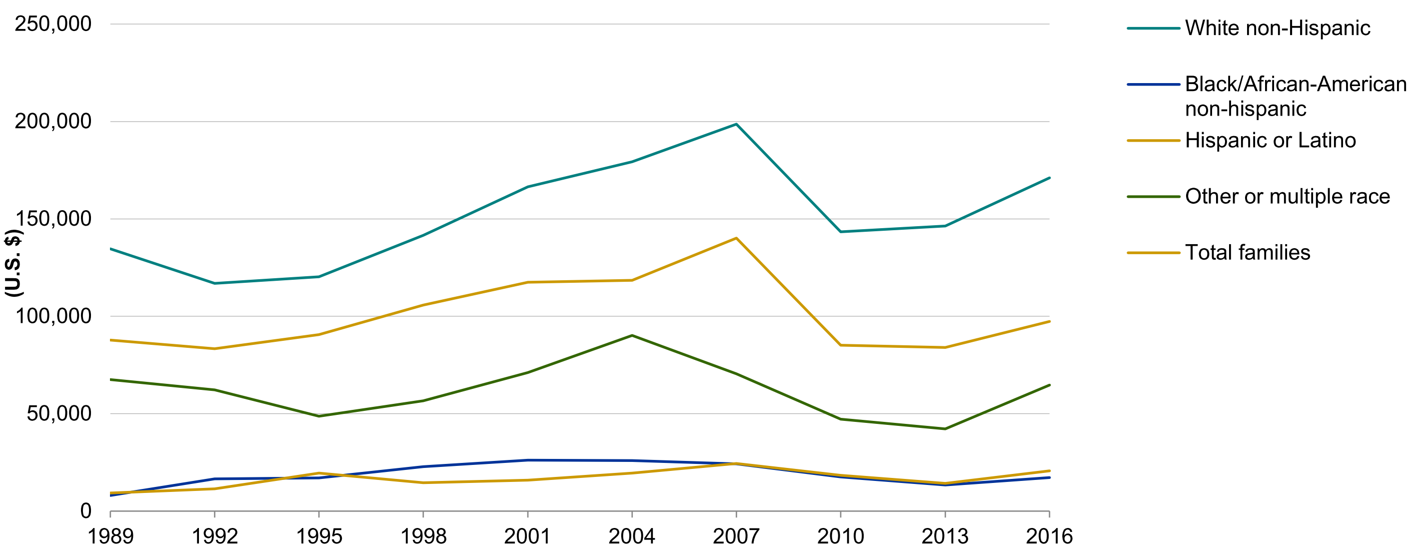
U.S. workplaces have yet to achieve equal opportunity for people of different races, and policies have so far not fully addressed the widespread issue of racism. According to the Center of Public Integrity and the Washington Post, from 2010 to 2017, one million discrimination complaints were filed with the U.S. Equal Employment Office Commission. More than 30% of these cases related to racial discrimination.

Labour Market Outcomes Are Rooted In Systemic Racism

The Black community has long been subject to civil and human injustices that have contributed to a vicious cycle of low educational attainment, high unemployment, and concentrated poverty. This has made it difficult for Black people to enter the workforce, advance in higher wage work, and accumulate generational wealth. Poverty serves as a systemic hurdle to Black employees because it creates barriers to higher educational attainment, thereby limiting their ability to procure employment and financial opportunities that would enable wealth accumulation. In 2018, the Kaiser Family Foundation revealed that Black Americans have the second-highest poverty rate in the U.S. (after Native Americans, another highly marginalized group). The study also highlighted a striking wealth disparity; while the median net worth of a white household in 2016 was $103,000, for Black households it was only $9,200 (see chart 1).

Chart 1

The Staggering Racial Earnings Gap Persists
Median family net worth in the U.S.



Source: U.S. Federal Reserve.
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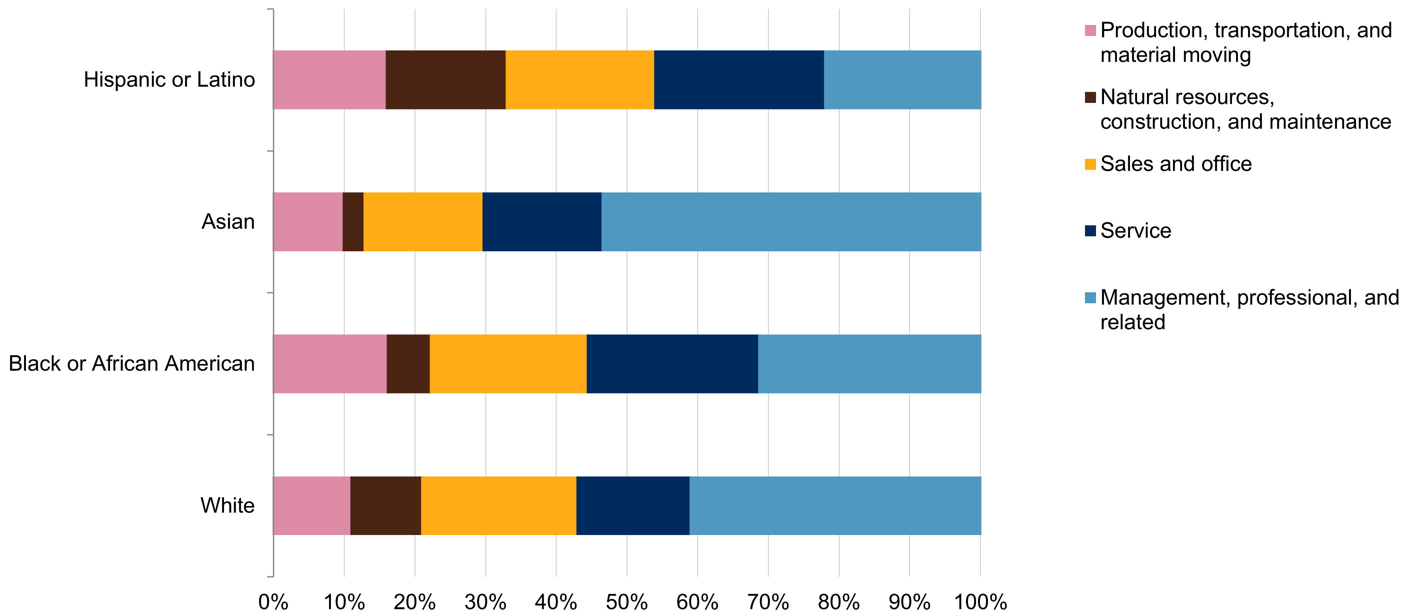
Yet, structural hurdles and enduring biases have also historically disadvantaged Black jobseekers, regardless of educational attainment. In the U.S., only 31% of Black employees are in management or professional positions, and a low proportion is in upper management positions (see chart 2).

Chart 2

Black Employees Are Largely Underrepresented In Management And Professional Occupations

Educational attainment of the labor force, age 25 and above in the U.S.



Data based on 2018 annual averages. Source: U.S. Bureau of Labor Statistics.

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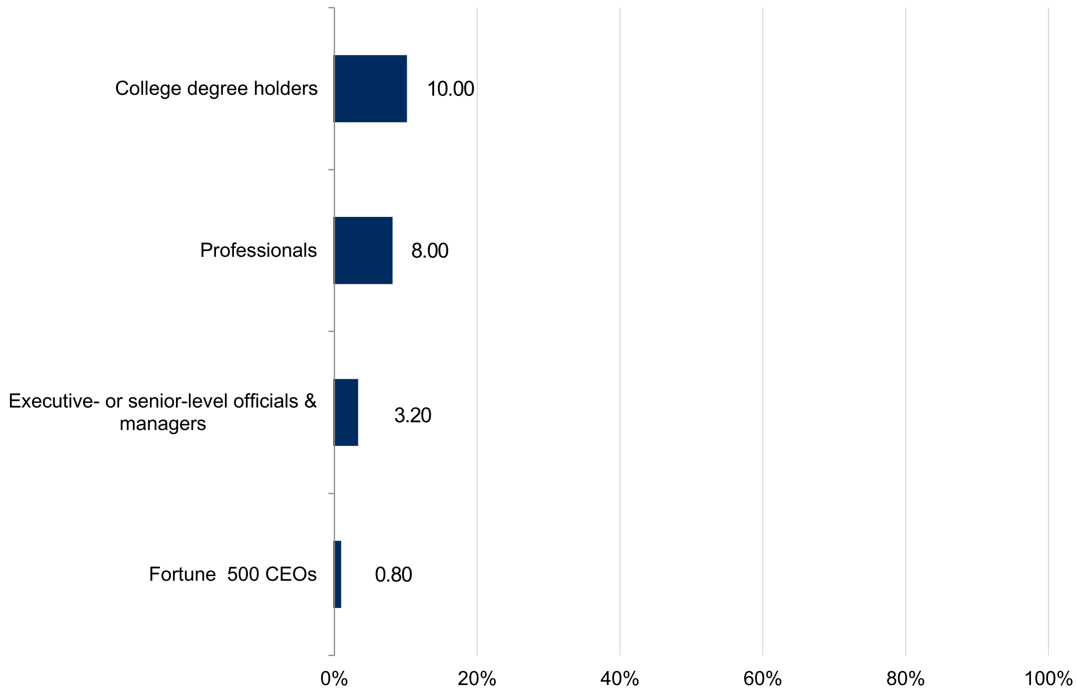
What's more, Black employees are often held to higher standards than their white counterparts. A 2015 study by the National Bureau of Economic Research found that Black workers receive extra scrutiny in the workplace, leading to lower wages, slower promotions, and sometimes even job loss. This legacy may also create an additional barrier to career advancement, which is apparent in the low proportion of Black employees in upper management positions. Of the Fortune 500 companies, Black employees only account for 3.2% of executive and senior management and only 0.8% of CEOs (four in total) are Black (see chart 3).

Chart 3

Black Employees Are Underrepresented In Management Positions In The U.S.



Source: Center for Talent Innovation Paper "Being Black in Corporate America".

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Diversity And Inclusion Policies Are Only The First Step

In our opinion, D&I programs are an important mechanism for improving racial equity in the workplace. They aim to link a company's strategies, mission, and business practices in a way that supports demographic differences among talent and enables an environment in which all employees are empowered to contribute their unique views and perspectives. As D&I programs have evolved, they've begun to encompass initiatives such as targeted recruitment, diversity education and training, career development, mentoring, and grievance procedures. Done well, D&I programs offer several business benefits, from improved productivity to innovation, which help boost a company's ESG performance by helping it anticipate changing consumer preferences and consumption patterns.

Several studies have investigated the link between diverse workforces and a firm's financial performance. According to a 2020 McKinsey & Co study, companies in the top quartile for racial and ethnic diversity are 36% more likely to show financial returns that exceed the national industry median. Another study by sociologist Cedric Herring, during his time at the University of Illinois, Chicago, found that companies with the highest racial diversity were able to generate nearly 15x more sales revenue than firms with the lowest levels of racial diversity. Herring suggests that racial diversity is the most important predictor of a company's competitive positioning, and a better indicator of sales revenue and customer attainment than a company's size, years in business, and overall employee headcount. Diversity has also been linked to increased innovation potential. Studies show that diversity supports, enhanced creativity, more informed decision-making, increased capacity for innovation, improved customer acquisition, stronger revenue-generating potential, and better talent management.

Analyzing Diversity Remains A Challenge

Where available, we analyze a company's ethnic diversity metrics as one indicator for a diverse workforce. Businesses tend to focus mainly on the workforce composition and on recruiting employees from different identity groups, including race, gender, age, culture, cognition, and education. Social equality activists are increasingly demanding that companies release diversity statistics, thereby holding them accountable for persisting race gaps.

Although transparency practices are improving, the availability of data is a persistent issue. According to the U.K.'s Business in the Community (BITC) Race at Work 2018 Scorecard report, only 11% of employers report ethnicity and pay data. In France, a race-neutral policy approach to education and employment stands in contrast to that in other European countries. It is illegal for employers or institutions in France to ask about someone's race or ethnicity. The intent of this was to avoid discrimination. However, in 2006, more than 25 years after the 1978 law prohibiting the collection of ethnic data, a poll by research company TNS-Sofres showed that more than half of France's black adults said they had experienced racial discrimination. Furthermore, companies more frequently report strictly on percentages of minority employees without commenting, directly or otherwise, on the positions they occupy. This can mask some disparities in terms of job level, promotions, or lack of diversity in certain roles.

We also take into consideration companies' strategies to increase diversity including quotas, targets, or affirmative action policies. Over the past few years, several European countries have proposed or implemented diversity quotas for boards of companies, principally to increase female participation. The U.S. state of California followed suit in 2018, while legislation is pending in other states. Although still controversial, quotas have helped increase the number of women on boards. Similar policies on ethnic diversity are largely missing. In the U.K., the 2017 Parker Review set a voluntary target for FTSE100 boards to have at least one director from an ethnic minority group by 2021. The Review's 2020 update shows some progress but not full compliance with the recommendations.

Regardless of the approach a company takes to increase workforce diversity, it is clear that quality data is a necessary ingredient of an effective diversity strategy. As such, we believe transparency at all levels of the organization is imperative for companies to solidify the trust and loyalty of their employees, suppliers, and shareholders. In turn, this will help boost productivity and strengthen the potential for innovation, thereby supporting ESG performance.

The Emphasis Must Be On Inclusion

Recruiting ethnic minorities does not necessarily translate into an environment that's free of discrimination, allowing each employee an equal opportunity to advance. In our opinion, employers with a culture that tolerates discriminatory practices and microaggression are vulnerable to productivity lapses, decreased innovation, and lower creativity. Therefore, we believe the success of D&I initiatives appears to hinge on the inclusion side of the equation, which should ensure employees feel their contributions are appreciated and full participation is encouraged. According to author and inclusion strategist Verna Myers, Vice President of Inclusion Strategy at Netflix, "Diversity is about being invited to the party. Inclusion is about being asked to dance."

Analyzing inclusion practices could provide better insight into how companies manage more covert forms of discrimination associated with microaggression. In a U.S. national survey of over 3,700 office workers conducted by the National Opinion Research Center (NORC), 58% of black respondents said they have encountered racism at the workplace. According to the NORC, workplace prejudice often shows up in subtle ways, through microaggression, typically during employee interactions through comments that proliferate Black stereotypes. Examples include referring to Black employees as intimidating, or unprofessional because of their hairstyles, thus creating a situation in which these employees are perceived as "not right" for the job. Such a toxic environment can go undetected by senior management, particularly when people of color are underrepresented at the workplace and in management positions. Many instances of discrimination also likely go unreported, making it even more difficult to expose covert forms of racism in corporate culture. In some cases, microaggression could ultimately result in higher staff turnover rates, one of the factors that informs a company's Social Profile in our ESG Evaluation.

Many corporate leaders have committed additional resources to D&I programs in the wake of the Black Lives Matter protests. However, the success of these programs lies in how they resonate with employees. Literature on this topic suggests that achieving true inclusion requires a shift in the organizational culture to acknowledge the value of different backgrounds, expose conscious and unconscious biases, and create an atmosphere of respect and empathy. Managers, in particular, play a crucial role in employee development and are therefore important stakeholders in supporting racial inclusion. However, many are not necessarily inclined to reflect on or talk about racial discrimination, and without a business culture that fosters inclusion, meaningful change is unlikely to result.

Companies have started promoting conversations with Black employees to better understand their experiences, which we believe is a starting point. Ultimately, achieving a sustainable diverse workforce and addressing system racism will require continued leadership and accountability. A 2018 Boston Consulting Group study of more than 1,700 companies in eight countries, across different industries and sizes, found that five key factors help diversity to flourish:

- Participative leadership: managers support employee contributions;
- Strategic priority: top management and the CEO clearly demonstrate support for diversity;
- Frequent communication: free and open communication is encouraged within teams;
- Culture of openness to new ideas: employees feel that they can express their perspectives without fear of retaliation; and
- Fair employment practices: employees with equal roles achieve equal pay, and companies enact robust anti-discrimination policies.

Looking To The Future

The Black Lives Matter movement has ignited a broader awareness of racism in society that has put the corporate sector in the spotlight. We believe companies' diversity track records will be increasingly scrutinized, making a diverse and inclusive workforce a reputational imperative. In our view, more corporate entities will treat the challenge of workplace diversity as they would any other existential risk, and therefore gather the right information, including opting into voluntary diversity initiatives, to make the most informed choices.

A Call To Action: The Race At Work Charter

In collaboration with the U.K. government, the BITC established the 2018 Race at Work Charter detailing five actions all employers, regardless of sector, could undertake to further support diversity and inclusion. Since the Charter's inception, more than 100 companies have added their signatures, including the National Grid, Goldman Sachs, and Deutsche Bank. By joining this initiative, companies are committing to taking meaningful action against discrimination in the workplace. The five actions are to:

- Appoint an executive sponsor for race.
- Report ethnicity data metrics and monitor progress.
- Commit, at the Board level, to zero tolerance of harassment and bullying.
- Clearly state that promoting equality in the workplace is the responsibility of all managers.
- Take meaningful action to support the career progression of ethnic minorities.

The success of a company's D&I efforts will be reflected in several indicators, including: the proportion of Black employees in the workforce overall, also in management and leadership positions; and the pay gap between employees in similar roles. Large, technologically advanced companies will likely be among the first to back their D&I commitments with meaningful targets and report regularly on progress. In the end, an effective, inclusive framework that supports long-lasting diversity and ESG goals depends on sound communication and ongoing commitment of employees at all levels of the organization.

Related Research

- Environmental, Social, And Governance: Why Corporations' Responses To George Floyd Protests Matter, July 23, 2020
- The ESG Pulse: Social Factors Could Drive More Rating Actions As Health And Inequality Remain In Focus, July 16, 2020
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External Research

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- https://journals.sagepub.com/doi/abs/10.1177/000312240907400203
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- https://www.bitc.org.uk/race-at-work-charter-signatories/

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