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Using Compensation to Promote Diversity, Equity, and Inclusion

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With rising calls for social reform in 2020, investors and the media are focusing attention on companies' efforts for diversity, equity, and inclusion (DEI). They're calling on companies to "do better" with new and expanded DEI initiatives. To boost these initiatives, many boards are considering ways to link results with executive pay. Yet, getting this right is nuanced and unique to each company. Missteps can lead to unintended consequences or even undermine a company's broader commitment to DEI.

To guide boards through this process, we outline frameworks and considerations below to ensure that the implementation of DEI metrics have a meaningful impact and minimize any unintended consequences.

Evaluating Readiness for DEI in Incentive Programs

DEI metrics for performance-based compensation are currently used by ~20% of the Fortune 200 companies, mostly in the annual incentive plan as part of a scorecard or individual performance assessment (vs. a quantitative metric with an explicit weighting). With increased focus on these topics, we expect both the prevalence and prominence of DEI metrics to increase markedly in the next few years. Several companies including Nike and Starbucks have already recently announced that they will be tying executive pay to DEI metrics for the first time.

By tying DEI to compensation, a board can strengthen accountability for progress and send a clear signal about the company's priorities. Several companies have already added these metrics to their incentive designs for 2021, or increased their prominence. Others are considering these metrics for 2022.

Before diving in, boards should first identify the aspects of DEI that are most material to the company's strategy and long-term success (e.g., is there a greater urgency to improve employee engagement and sense of belonging or is there a more pressing need to focus on increasing representation in senior leadership roles?). Does the company have a clearly defined strategy for tackling these DEI priorities? Are there key milestones or goals to gauge success against that strategy? Has the company made external commitments with respect to DEI goals?

After these initial steps, boards can then evaluate the objectives of increasing the prominence of these DEI priorities. Is the main focus to materially change executives' behaviors? Or is there a more pressing need to respond to external pressure to include DEI and signal to internal and external stakeholders the importance of DEI to the company? The prioritization of underlying objectives will help boards determine the right approach and emphasis for addressing DEI. For some boards, this might mean addressing DEI directly through the incentive program. For others, DEI may be better addressed through other means like performance reviews or in a company's external corporate social responsibility (CSR) report. (See Figure 1.)

FIGURE 1. *Decision Tree for Considering Readiness of DEI in Incentive Programs*

1 Identify aspects of DEI most material to the business strategy

Has the company identified the aspects of DEI **most material and connected to the company's strategy** and long-term success?

Has the company **articulated a plan to execute** on these strategic DEI priorities?

Has the company identified **key milestones or goals** to gauge progress in executing against the plan?

2 Determine key objectives for elevating critical DEI priorities

The prioritization of the **underlying objectives** will help determine the right approach and emphasis.
Is the main focus to:

a. Drive greater accountability or materially change behaviors?

b. Magnify the relative importance of DEI?

c. Signal DEI's importance internally or externally?

d. Respond to or anticipate external pressure?

e. Galvanize the broader organization and culture around shared commitments?

Do the **process and behaviors** matter as much as, more than, or less than the results?

3 Consider the most effective means for achieving objectives

Is DEI better addressed by directly tying the goals to pay outcomes, or by other means such as performance reviews, promotions, and external reporting?

If the former, are the current conditions optimized to maximize the impact of a DEI component in the compensation program? (See Figure 2.)

FIGURE 2. *Conditions Needed to Optimize DEI Metrics in the Pay Program*

1 There is a well-articulated strategy for execution and clarity on how success will be defined	2 There is an understanding that elevating DEI may send unintended signals (e.g., tying pay to DEI but not sustainability may send a message about company priorities)	3 The DEI metric(s) are part of a balanced, comprehensive assessment. Narrowly defined metrics can miss the spirit of the overall commitment (e.g., meet recruiting targets, but miss on culture)
4 There is a willingness to maintain a DEI component in pay for an extended period of time	5 There is a willingness to set real, stretch goals that are durable and can withstand shifts in strategy	6 If goals are missed, boards are willing to disclose externally how or why goals were not achieved

How to Optimize the Use of a DEI Metric

As with the addition of any metric in an incentive program, boards should carefully consider the current conditions before implementation to optimize the effectiveness of the new metric. In this case, if boards decide that DEI will be more appropriately addressed through direct incentives, they should check to see if the majority of the conditions listed in the exhibit below would be achieved. To the extent these conditions are lacking, boards may prefer to delay implementation, or address DEI outside the pay program. (See Figure 2.)

Three Paths Companies Can Take

As companies conduct materiality assessments and evaluate the conditions listed above, we see three potential paths companies can take with respect to elevating the importance of DEI: (1) commit to or enhance external reporting of DEI goals and progress, (2) incorporate a scorecard within the incentive program that includes DEI metrics, and (3) introduce DEI metric(s) with an explicit weighting in the incentive program.

1 *Address DEI outside of the compensation program and drive high accountability at the organizational level.*

If companies are not yet ready to incorporate DEI as an incentive metric, they can consider publishing a detailed DEI report that includes commitments, metrics, progress, and an overview of the key initiatives. Since Boards typically review external disclosures and provide input, DEI initiatives that are communicated externally will likely receive increased attention and prioritization from boards and management teams. The DEI report could be included as part of the company's broader CSR report or serve as a standalone report. Salesforce has taken this approach by publishing DEI goals and providing quarterly equality updates while keeping its incentive programs tied strictly to financial performance.

2 *Drive greater individual accountability by incorporating a scorecard that includes DEI in the incentive program.*

A scorecard approach allows for boards to select multiple metrics, creating a more balanced assessment of DEI and mitigating any unintended consequences of boiling DEI down to just one or two metrics. Scorecards also allow companies to show commitment and progress on DEI initiatives, while allowing for boards to exercise discretion as to how the DEI goals are achieved. As part of its fiscal 2021 annual incentive plan, Microsoft has diversity and inclusion metrics as part of the culture and organizational leadership category of its larger operational scorecard. While the culture and organizational leadership category has a 10% overall weighting, the metrics within the category do not have explicit weightings, giving the board flexibility to assess diversity and inclusion holistically.

3 *Dial up accountability even further by selecting one or two DEI metrics and assigning explicit weightings to metrics as part of the annual and/or long-term incentive plan.*

This approach elevates the importance of DEI both internally and externally. That said, it increases pressure on metric selection and the goal-setting process. Alliant has taken this approach by including two diversity goals which target certain percentages for people of color and women in its annual incentive plan with a combined 5% weighting. Uber has taken a less conventional approach by including DEI in its long-term incentive program. Its 2019 performance stock units (PSUs) are tied 25% to 3-year goals aimed at increasing managerial representation of women and underrepresented employees.

While we expect DEI metrics to become more prominent in executive pay, we also see the challenges with getting them right. Rather than rush into the decision, boards must assess DEI within their companies' strategies. While incorporating DEI into the pay program sends a strong signal of its importance, boards have other means of creating accountability and elevating DEI as a priority. Implementing a DEI metric may not be appropriate at this time for every company; however, if thoughtfully designed, doing so could create strong alignment with a company's strategy and initiatives. ■

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