Teneo
The Global CEO Advisory Firm

For Good Measure

Current Best Practices in Tying Diversity, Equity, and Inclusion Metrics to Executive Compensation

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Overview

Amid the ESG (Environmental, Social and Governance) investing revolution, companies are currently grappling with how to incorporate ESG measures, particularly those relating to DEI (diversity, equity and inclusion), into their executive compensation programs.

We reviewed 68 companies that disclose DEI metrics in their executive compensation design (and where available, non-executive employee population pay design) to provide insight into current practices in tying compensation to DEI performance. As this practice is in flux, our review is intended to provide a glimpse of what the future state of DEI incentive metrics might look like. We sought to identify which practices are most impactful in driving progress and accountability, as well as which practices are viewed favorably by investors and proxy advisors.

Until recently, companies generally included DEI performance in subjective assessments of executives' individual performances, and these assessments only carried a discretionary and, in most cases, nominal impact on pay. However, a new approach is emerging following recent public commitments from large companies to improve DEI performance amid heightened public focus around systemic racism and the disproportionate impact of COVID-19 on people of color.

Several of these companies have created an additional degree of accountability around DEI performance by tying a quantified portion of C-suite executive (and increasingly, non-executive) incentives to pre-set and measurable goals that ladder up into these long-term commitments. This approach, when paired with fulsome disclosure of the goal determination process, has emerged as best practice for those seeking to tie DEI performance to executive pay. Companies that decide to move forward with establishing DEI incentive compensation metrics must consider the following: what metrics and goals should be chosen, how to structure their connection to compensation, what population should be affected, and over what time period should performance be measured. This perspective is echoed by several shareholders and other stakeholders. BlackRock, for example, recently clarified that “where companies choose to include [ESG ties to compensation], those metrics should be aligned with a company’s strategy and business model and should be as rigorous as other financial and operational targets.” Based on the available disclosure, we identified the following key considerations and best practices for companies seeking to include DEI metrics in their pay design.

Methodology

Our analysis focuses on large companies (the largest 100 companies in the Fortune 500) as well as those that publicized DEI compensation ties or that were otherwise publicly committed to improving DEI performance. While the study includes one European company that announced DEI incentive goals, all other companies analyzed are headquartered in the US. Companies in the study provided varying levels of detail about their use of DEI metrics, particularly those that took a subjective and discretionary approach. Some simply noted that diversity was a consideration in regards to pay, while others provided granular details on specific metrics and goals and whether the impact on compensation was discretionary or quantitative.

Looking Ahead

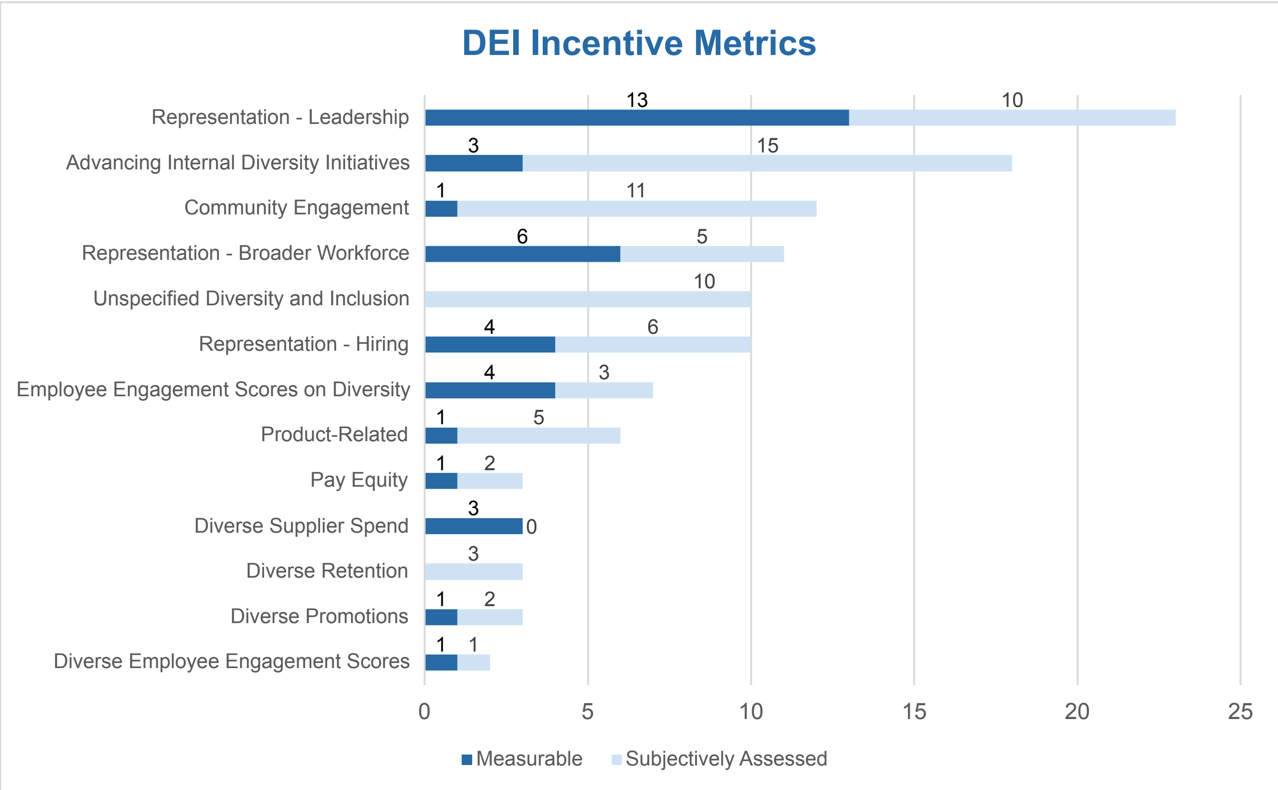
The Future of DEI Incentive Metrics

- Accountability for DEI to spread beyond the executive team, to reflect the role that all employees play in driving progress on DEI.
- Transparent and measurable metrics that align with long-term DEI goals and corporate strategy are favored by investors.
- Progress on diverse representation goals will remain important, but expect goals to evolve and better reflect the company’s long-term DEI strategy with metrics such as employee survey results, spend with diverse-owned suppliers or new DEI-related products or services.
- A shift towards defining exactly how much pay is at risk based on DEI performance re-enforces that it is a priority and provides additional accountability.
- Thoughtful disclosure of how specific DEI incentive metrics and targets comport with the company’s long-term strategy and positively impact shareholder value is necessary.

Metric and Goal Selection

The best DEI metrics support long-term success and are easily defensible.

Strong DEI incentive metrics align with the company's long-term strategy. The most common metric is diverse representation among leadership. Well-chosen DEI incentive metrics both support the immediate needs of the company and conform with its long-term strategy, incentivizing behavior and focus to get the company where it needs to be. Diverse representation among leadership is by far the most common DEI incentive metric. A diversity of perspectives at the top has been shown to create a more equitable and inclusive culture, while also contributing to improved DEI performance across all dimensions of a business. Representation among new hires and the employee population overall were also common metrics for companies that used measurable goals. Demonstrating clear improvement in these areas is likely to become even more important as companies are pressured to disclose EEO-1 and other diversity data. While representation metrics are common, companies should go beyond representation to include quantifiable and time-bound progress of other key metrics such as improvements in an inclusion index, employee survey results, or the establishment of key initiatives such as implementing unconscious bias training. Companies do not need to limit themselves to a single DEI metric, and more than half of study companies used more than one DEI metric in their incentive plans.



What gets measured gets managed.

Measurable, pre-set DEI metrics are growing in popularity and preferred by investors for their transparency. Tying incentives to pre-set and measurable DEI goals, rather than assessing performance subjectively, affords transparency to both recipients and investors by clearly defining success. Measurable goals can be numerical, such as diverse representation, or can be assessed on a binary yes/no basis, such as establishing key initiatives. A Teneo study of S&P 500 companies found that over half of 2021 Sustainability Reports included at least one demographic target, with 42% of companies including both gender and racial/ethnicity goals. By setting goals, companies are treating DEI like any other business priority, ensuring accountability and tracking progress.

While only a third of the companies assessed currently utilize measurable goals, the practice is growing. Of the 18 companies in the study that announced new DEI pay elements for 2020, 2021, and 2022, only two plan to assess performance subjectively. As more companies publicly announce company-wide DEI goals and publish DEI data, the trend towards pre-set targets will likely accelerate as investors press for clear progress and accountability.

In the 2021 ISS Benchmark Policy Survey, when asked whether non-financial ESG-related metrics should be incorporated into executive compensation, over 50% of investor respondents replied that they should, but only if the metrics are specific, measurable and transparently communicated. Following that survey, ISS adopted a new policy for the UK and Ireland, stating ESG incentive performance targets should be material to the business and quantifiable for compensation to be considered performance based. As with other compensation trends, this view could make its way across the pond to the US market.

Consider using a combination of individual and company-wide goals.

Most study companies use the same company-wide goals for all executives. Incorporating company-wide and individual DEI goals enables a tailored approach. Of those companies in the study who provided details about their DEI incentive goals, about two-thirds linked executive pay to DEI performance on a company-wide basis. Therefore, all executives received the same score or payout level that was not affected by individual goals that only impacted certain executives.

> "I've long been against diversity targets, thinking of them as quotas. But I also have looked at the results of activities in California and in the UK where quotas have literally helped to transform the complexion and the gender of boards."

- Ursula Burns
Chairwoman, Teneo

Utilizing shared, company-wide goals for executives can encourage a culture where DEI is recognized as a shared responsibility for all employees, rather than a specific department such as HR. However, this approach can be problematic when departments or teams have widely different DEI needs. On the other hand, considering DEI performance in an individual performance assessment alone may be viewed as less transparent and less impactful by investors. This is particularly true if individual DEI performance is assessed subjectively, and the impact on pay is discretionary. Pairing company-wide goals with individual goals enables a tailored approach to drive shared ownership and boost personal accountability, especially around division-specific goals such as expanding a diverse-owned supplier program or a new DEI-related product offering.

Progress necessitates evolving goals.

Most study companies achieved their DEI incentive goals. Consider evolving DEI metrics as they are achieved so that goals remain rigorous and aligned with long-term strategy. After DEI goals have been incorporated into incentive design, the question arises of what to do once these goals are achieved. There were several companies that either phased out or reduced the weighting of DEI goals as they made progress. However, establishing a fully diverse, equitable and inclusive culture requires continued work over many years and across a variety of metrics. Prudential, an early adopter of DEI incentive metrics, shifted priority from its recently achieved goal of representation among top management to other DEI metrics, such as representation in different managerial layers of the company and diverse employee engagement. Whether determined subjectively or using measurable goals, DEI performance was almost always assessed at or above target. Only one company in our analysis fell below target. While this may indicate that including DEI metrics in compensation achieves results, stakeholders will likely begin to question the rigor of DEI goals when pre-set goals are not used or disclosed.

Pay Design

Quantifying the impact on pay makes a difference.

Communicating exactly how much pay is at risk based on DEI performance creates accountability. The most common weighting for DEI metrics in the STI and LTI is 10%. Quantifying the impact on pay is considered more transparent from a shareholder perspective, and the pay affected is viewed as more strongly performance based. In the study, companies that assessed DEI performance subjectively were more likely to take a discretionary approach in determining its impact on payouts, either through an unweighted portion of a strategic scorecard that determines incentive compensation or through an individual performance component. Companies that used measurable goals were more likely to quantify the impact of DEI performance on pay in a weighted component or modifier.

The most common weighting was 10% of the incentive payout for those that quantified the impact. However, the range of disclosed weightings varied from less than 5% of the bonus to determining 100% of the PSUs earned. There is no universally ideal weighting system, but investors and proxy advisors have questioned whether weighting DEI and other ESG-related metrics below a certain level is effective at holding executives accountable for performance. Conversely, proxy advisors have criticized companies that have tied a very large portion of compensation to DEI metrics without providing a clear explanation of what specific targets they used, how they were determined, and how they drive shareholder value.

Alignment with long-term DEI goals is key.

While DEI metrics are mostly linked to short-term plans, they are also increasingly incorporated into long-term incentives to align with the strategy timeline. While most companies embedded diversity considerations in their annual incentive, 17% of companies in the study incorporated DEI metrics in long-term incentive (LTI) design, an emerging best practice. As LTI typically constitutes the largest component of executive pay, this adds a higher level of accountability from a payout perspective and aligns with shareholder preferences. In ISS' recent policy survey, investor respondents noted a slight preference for including ESG metrics in long-term rather than short-term incentives (STI). However, short-term DEI goals can be appropriate to drive accountability against program implementation and foundational progress necessary for long-term success. Whether short-term or long-term goals are used, companies must ensure that they comport with the company's long-term strategy and that they clearly communicate the connection to investors. A handful of companies in the study bridged the gap between short-term and long-term measures by implementing annual DEI goals in STI, while also explaining their connection to longer-term announced ESG goals for 2025 and beyond.

Consider cascading incentives throughout the organization.

Evidence shows that DEI metrics are increasingly incorporated in non-executive employee pay plans, creating a culture of accountability across the organization. Establishing a DEI-focused culture is the responsibility of all employees, so DEI metrics don't need to be reserved for executives. As disclosure of pay information is only required for the CEO, CFO and the other three most highly paid executives, publicly available information on non-executive pay design (also known as broad-based employee pay) is limited. However, we have identified several companies that have linked broad-based employee pay to progress on DEI initiatives. For example, several companies incorporated diversity in hiring and mentoring into subjective individual performance assessments, while a smaller number of companies used measurable department-wide or team-wide goals. While most of the companies that tied DEI to broad-based pay left the impact on incentive payouts discretionary, an increasing number are quantifying the impact on payouts. One company disclosed that 10% of every employee's bonus was tied to some form of DEI metrics, such as retention and representation, but the goal varied by department. As with executive incentives, ensuring that employee DEI goals align with the company's DEI priorities and long-term strategy is key.

Addressing Investor Concerns

Greater investor focus necessitates thoughtful disclosure.

Investors are vocal about the need for clear disclosure of DEI incentive metrics and goals and their impact on pay. As the use of DEI incentive metrics proliferates, it will become increasingly important for companies to clearly explain the connection between their chosen DEI incentive metrics and targets and holistic company performance. Most institutional investors do not maintain a hard policy on whether companies should include DEI metrics (or any ESG-related metrics) in their incentive plans, but they do not discourage it. Many have indicated that ESG metrics are important insofar as they support the company's long-term performance, and that this connection must be explained by the issuer.

Vague disclosure, paired with above target performance assessment, could be viewed as greenwashing. Strong disclosure includes the specific performance metrics, the rationale for why they were chosen, and their materiality to the company's long-term strategy and success. If specific performance targets cannot be disclosed and in cases when non-measurable metrics are used, companies should include a discussion of why the targets are rigorous and challenging, the factors used to determine success, and how these factors impacted the ultimate payout. Additionally, this rationale should comport with existing DEI and ESG disclosure, such as the company's sustainability reports. If a selected metric departs from a company's ESG materiality matrix, then the reason why it was chosen must be addressed.

> "It is important that companies using sustainability performance metrics explain carefully the connection between what is being measured and rewarded alongside business goals and long-term performance. Failure to do so may leave companies vulnerable to reputational risks and undermine their sustainability efforts."
>
> **- BlackRock**

Anticipate increasing stakeholder scrutiny of DEI goals.

Expect investors to dig deeper into DEI metric choice and rigor. As more companies disclose diversity data and set long-term DEI goals, we expect greater adoption of measurable DEI incentive goals that impact a pre-determined portion of pay. Stakeholder focus is likely to shift from whether companies link pay to DEI metrics to assessing the rigor of those goals, their alignment with long-term growth, and the degree to which they impact pay and create accountability. A thoughtfully chosen metric and structure, combined with clear and fulsome disclosure, is a winning combination in creating and demonstrating executive and employee accountability for advancing DEI as a business priority.

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