REPORT OF THE NACD BLUE RIBBON COMMISSION

2020 UPDATE OF THE DIVERSE BOARD

MOVING FROM INTEREST TO ACTION

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MEASURING, SETTING GOALS ON, AND REPORTING ON DIVERSITY, EQUITY, AND INCLUSION

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HOW TO USE THIS TOOL

Internal Labor Market (ILM) analysis is an analytic tool to help organizations drive desired outcomes. To illustrates how it works, this article shares specific examples as applied to large US-based companies interested in improving diversity, equity, and inclusion. Boards can use these examples to inform their own efforts to improve outcomes in their own organizations.

Organizations are facing pressure from stakeholders and shareholders alike to prioritize diversity, equity, and inclusion (DE&I). Activist investors are pressing for information, and the US Securities and Exchange Commission recently issued a human capital reporting mandate that appears to encompass aspects of DE&I.[1] Organizations themselves need to ensure that they can access and leverage diverse talent to drive innovation and performance. To meet these growing standards, boards need to access the right data to provide oversight and drive success.

Mercer has supported many of the companies leading the charge on DE&I with analytics to measure and accelerate progress and to support disclosure. Informed by that experience, we provide a framework to analyze data here that boards should consider to ensure that they can effectively support their management teams and report to shareholders on this critical topic.

A FRAMEWORK FOR ASSESSING AND ACHIEVING DE&I
INTERNAL LABOR MARKET ANALYSIS

An organization hires employees, develops and advances them, and, potentially, sees them leave. The movement of these employees within the organization, and the rewards allocated to them as they move and perform, constitute an internal labor market (ILM). ILM analysis is a framework to assess how these workforce "flows" and associated rewards occur and can be adapted to drive desired change.

Internal Labor Market Maps

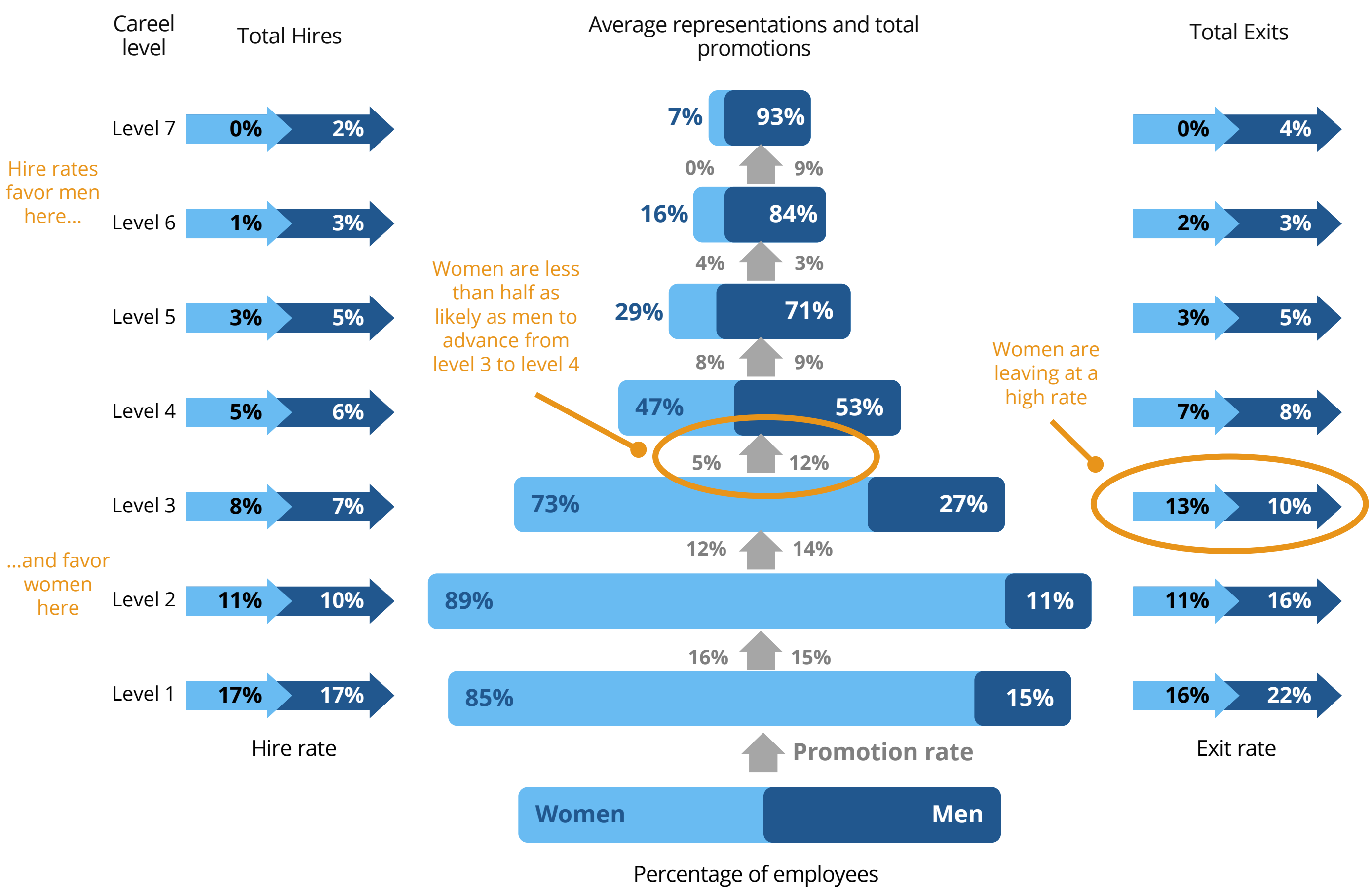
A core diagnostic tool of ILM analysis is an ILM map, which can be readily produced by the human resources information system (HRIS) reporting team. The ILM map is a single picture that shows employee headcount by career level, and for the most recent one to three years, average annual hires, promotions, and exits from each level. In breaking down the ILM map by gender and race/ethnicity, a board can assess representation deficits across the hierarchy and identify questions to ask management about specific pain points (e.g., hiring shortfalls, career "ceilings," and points of retention risk).

[1] Securities and Exchange Commission, SEC Adopts Rule Amendments to Modernize Disclosures of Business, Legal Proceedings, and Risk Factors Under Regulation S-K, August 26, 2020.

Figure 1 is a sample ILM map with statistics broken down by gender. Looking at the map, we see women's representation falls below 50 percent at career level 4, the first managerial level in this organization, and declines steadily from that point. Women are less likely to be hired into senior levels; women face a "ceiling" above level 3; and women are more likely to leave from level 3. The ILM map highlights opportunities to improve women's representation—in this case, enhancing recruiting into the senior ranks, supporting the development of managerial skills and/or ensuring equity in advancement, and strengthening the employment proposition, particularly at the managerial entry point. An ILM map supports deeper discussion on action plans with company management. For this company, eliminating an advanced degree requirement for some managerial roles and providing tuition support elsewhere were among the interventions considered.

FIGURE 1 **INTERNAL LABOR MARKET (ILM) MAP, BY GENDER**

Disguised case example



Source: Mercer

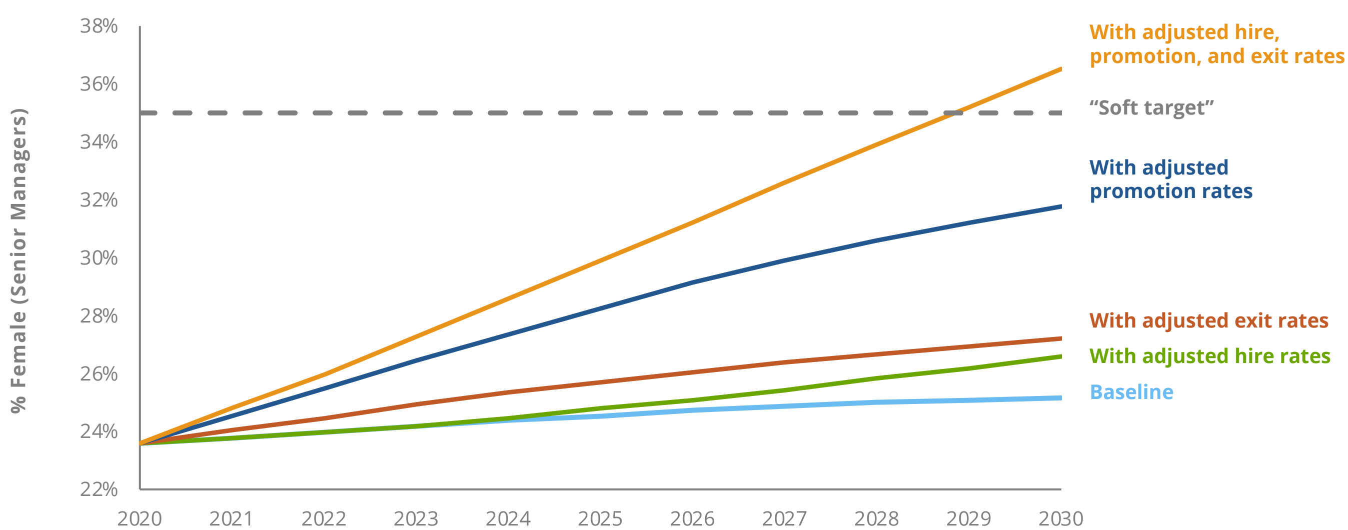
Note: Hires and exits are represented as percentages of average headcount at the destination level; promotions are represented as percentages of average headcount at the originating level.

Diversity Projections

The workforce flows represented in an ILM map can also be used to project the diversity of the future workforce and set representation goals. Figure 2 represents a set of diversity projections, focused on the future representation of women in senior manager roles over a 10-year horizon. The light-blue line shows the future representation of women if the rates of movement (i.e., hires, exits, and promotions) for women relative to men hold steady at current levels. The green, red, and dark-blue lines show how much better the organization could do if it achieves equity in hiring, exit, and promotion rates, respectively. Finally, the gold line shows how the organization could excel in its DE&I goals if it achieves equity across all of these rates together. The gold line represents an aggressive, but achievable, trajectory to inform goal setting.

FIGURE 2 **PROJECTING FUTURE REPRESENTATION OF WOMEN AMONG SENIOR MANAGERS**

Disguised case example



Source: Mercer

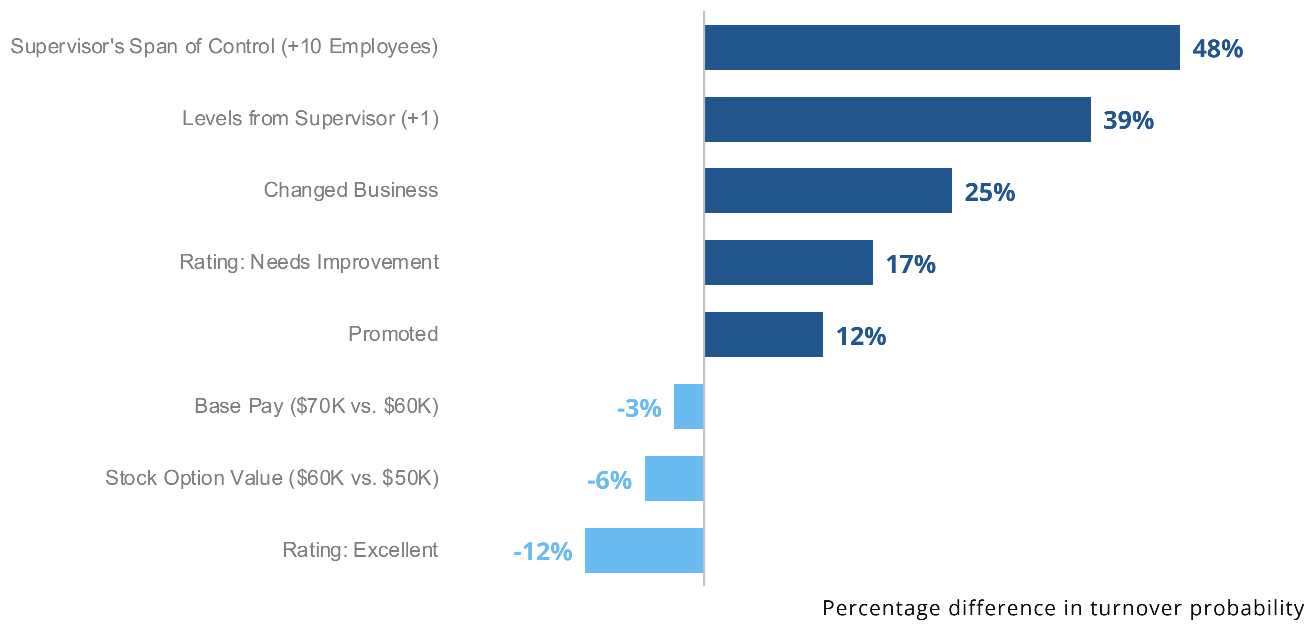
Statistical Modeling

Organizations leading the charge on DE&I rely on analytics to drive specific, tailored strategies to improve representation. ILM analysis includes statistical models that predict the probability of employee advancement and retention reveal the root-cause drivers associated with these workforce flows and inform effective interventions. Human resources functions have analytics teams that run these analyses or collaborate with domain experts, including labor economists and industrial and organizational psychologists.

Figure 3 shows an example of an ILM model that predicts employee exits based on various factors, including supervisory characteristics, employee mobility, and past rewards. The model parses out the independent effect of each of these factors on the probability of exit over a year. In this specific case, pay had a modest impact. Larger impacts were related to two factors. The first was supervision—managers who were further removed from their supervisees, either because they had more reports or because they were at more senior levels, saw greater turnover in a decentralized organization. The second was mobility—employees who changed roles, either moving between businesses or receiving a promotion, were more likely to leave, relating to inadequate onboarding and training. These findings were accentuated for women and people of color, driving the organization to strengthen its employee communications and training infrastructure to support DE&I objectives. Experience shows that the results of such models and, therefore, the implications for managing DE&I vary across companies.

FIGURE 3 **REPRESENTATION OF A STATISTICAL MODEL PREDICTING THE PROBABILITY OF VOLUNTARY EMPLOYEE TURNOVER BASED ON VARIOUS FACTORS**

Disguised case example



Source: Mercer

Pay Analysis

Fairness in the allocation of rewards can also be driven through reliance on ILM analysis. Many organizations have disclosed “adjusted pay gaps,” which assess differences in pay between groups after accounting for legitimate differences in, for example, employee experiences and roles. These pay gaps are derived from statistical models, which can also support targeted pay adjustments to reduce the gaps themselves.

Those disclosing adjusted pay gaps generally show differences of 1 percent or less between women and men (globally) and non-white and white employees (in the United States). Gaps in this range might be explained by the insufficiency of data. For example, while analyses generally rely on age as a proxy for workforce experience, the proxy is less accurate for women than men, as women are more likely to have breaks in their work histories. Despite such imperfections in measurement, many organizations—including those that disclose—have moved to eliminate pay gaps over time.

Pay gaps are proactively reduced in two ways:

1. **Targeted pay changes informed by analyses.** Statistical models reveal employees who, given their experiences and roles, are paid less than expected. Organizations can close gaps by focusing on those who are furthest from expectations in areas where there are differences in pay between groups; they can achieve further progress by focusing on the underpaid group itself. Organizations calibrate their strategies to optimize progress subject to budget constraints.

2. **Interventions focused on specific compensation practices.** Analyses can reveal that gaps arise through pay-setting at the point of hire, pay increases provided to employees who advance, or merit pay increases. Organizations can then address those gaps through policy and practice.

Pressure for organizations to disclose their pay equity situation will continue to rise. Boards should ask their management team to run analyses comparable to those run by disclosing companies and review any gaps identified. Boards can also ask management to share strategies and associated pay-adjustment budgets to achieve progress against gaps since disclosures themselves can reflect the impact of committed pay changes. The current and multiyear plan to reduce gaps should reflect collaboration between management and the board.

Sensing

Boards should ask for employee survey results to be broken down by gender and race/ethnicity. Following this, and depending on the circumstances, they should request that management drive focus group discussions to further compare the experiences and perceptions of different employee groups and assess the inclusiveness of the work environment. Even where there is equity relating to processes and outcomes, perceived bias can limit the value of diversity, stifling collaboration and innovation.

Figure 4 shows an example of results from an employee survey broken down by gender and race/ethnicity. The results illustrate how people in different demographic groups experience the organization differently and enable the organization to measure the inclusiveness of its culture.

FIGURE 4 **USING AN EMPLOYEE SURVEY TO MEASURE EMPLOYEE EXPERIENCE**

	Women (vs men)	Asian (vs white)	Black/African American (vs white)	Hispanic/Latino (vs white)
Access to opportunities (promotion criteria, fairness, options available	↓	↑	↓	↓
Interest in advancement	↓ `	↑	↓	↓
Compensation (pay, fairness in distribution of rewards)	–	↓	↑	–
Inclusion (free to share my opinions, accepted for who I am)	↑	↓	–	↑
Support from leaders (senior leadership advocacy of DE&I, career support from managers)	↓	–	↓	↑
Have a mentor	↑	↓	↓	↓
Adequate support from career development programs	↓	↓	↑	–
Stress/work-life balance	–	↑	–	↓

Disguised case example ↓ Less likely – No more or less likely ↑ More likely

3

Source: Mercer

BRINGING IT ALL TOGETHER **INFORMING DISCLOSURE FROM ANALYTICS**

In considering disclosure, directors need to ask for the right information. Given pressures from shareholders and employees, the starting point for disclosure is the adjusted pay gap. That is, after accounting for differences in factors that should drive differences in pay, is there any remaining difference that might be attributable to gender or race/ethnicity? The emerging standard set by companies that have disclosed is that gaps should be at 1 percent or less.

Of course, disclosure cannot end there. Companies should commit to actions to reduce gaps and should focus on remedial pay adjustments where warranted. Further, companies need to broaden the focus to address equity when considering opportunities to get into higher-paying jobs. This is a point of emphasis that activist investors are driving at when they press for the release of “raw pay gaps”—differences in the average or median pay levels between groups.

Raw pay gaps are hard to manage. They reflect pay inequities (i.e., “unequal pay for equal work”), as well as differences in the roles occupied by employees in different demographic groups. To address this broader notion of equity in earnings opportunity, companies should instead examine the representation of women and people of color in their senior ranks. A complete disclosure should speak to both the current state of representation and future goals.

The results from ILM analysis can inform a complete disclosure. Current and future representation of women and people of color as revealed by ILM maps and diversity projections, under different scenarios, can be examined and relied upon for this purpose. An effective disclosure should also represent actions the organization is taking to promote DE&I, potentially informed by statistical modeling. Such actions might include regular checks to counter bias (e.g., a regular pay equity review, aligned to the year-end process), unconscious bias training, recruiting and staffing standards, mentoring and sponsorships, leadership and rotation programs, educational support, and the establishment of affinity groups. Changes in survey results (e.g., engagement scores) by gender and race/ethnicity, in addition to improvements in representation, might be shared as reflective of the successes of such efforts.

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