Real ESG Accountability
Tying Your Company’s ESG Performance to Leadership Compensation
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In 2020, BP, the British oil and gas giant, announced that it would tie 20% of its executive compensation packages to an emission-reduction scorecard of the company’s operations—an increase from the previous threshold of 10%. BP is by no means the only multinational to explicitly link environmental, social, and governance (ESG) benchmarks to the salaries and bonuses of the women and men in the C-suite. Danone, the food products giant, also pegs 20% of the variable component of its CEO and chairman compensation based on how they have met the company’s various social and climate targets. McDonald’s, meanwhile, rewards its senior executives based on the company’s efforts to diversify its workforce and management ranks, aiming to reach gender parity in leadership by 2030.

These firms are among the steadily growing contingent of public companies that have incorporated ESG performance metrics into their executive compensation packages, as part of efforts to widen their accountability beyond shareholders. For example, in 2020, 31% of FTSE 100 companies included ESG measures in executives’ annual bonus requirements; in 2021, the number had grown to 51%. According to Sustainalytics’ own data, approximately 10% of companies globally link executive incentive plans to one or more ESG metrics.

Occupational health and safety (OHS) is by far the most common issue targeted. Indeed, many companies already have an ESG pay-link for OHS, especially those in industries where it is a material issue, such as energy, utilities, materials, and industrials. This existing incentive plan can provide a framework for building out a more expansive ESG-linked compensation program.
Stakeholders Seek Transparent Executive ESG Pay-Links

As with incentives linked to strategic financial and operational goals, ESG pay-links are intended to make executives more accountable for their assigned ESG portfolios. In light of increased attention to issues like climate transition, equality and diversity, human rights, and so on, it should be no surprise that calls for companies to link pay packages to ESG performance have been growing.

While the details of ESG-linked executive compensation vary from company to company and sector to sector, there are some common issues that performance is measured against. For example:

- Data security, privacy, cyber-compliance
- Diversity, equity, and inclusion
- Environmental stewardship, greenhouse gas (GHG) emissions
- Governance and stakeholder engagement
- Human resources, employee engagement, talent management
- Occupational health and safety
- Waste management and energy efficiency

Credible ESG pay-links are a form of disclosure that not only boosts transparency, but also signals a shift toward long-term thinking and risk-management. As this process gains momentum, executives’ performance will increasingly be judged according to how effectively they have promoted ESG targets and execution within their firms and respective divisions.
Interests Converging on Long-Term Value

The take-up by publicly traded firms has accelerated in the past four or five years as companies get the message to act from all sides. Institutional investors, in particular, have increased their use of ESG screening, which has forced many companies to consider a range of ESG measures like incentive plans. The call is being further amplified by Blackrock’s 2022 “Engagement Priorities” memo. For the first time, the memo includes new categories for companies to consider, including the impact of energy transition and ESG factors in incentive packages for executives.

This evolution in the structure of executive compensation is a continuation of earlier efforts by corporate boards and investors to align fixed pay and short-term incentives with wider corporate goals. One of the main tools to do this is key performance indicators (KPIs) geared to the role of particular individuals and their mandates within the firm.

“Accounting for the interests of key stakeholders in compensation policies recognizes the collective nature of long-term value creation.”

– Blackrock Engagement Priorities 2022
Views Around the World

Interest in ESG-linked compensation by institutional investors, boards, and stakeholders, is most prevalent in Europe. Sustainalytics’ data indicates that approximately 17% of European companies have implemented an ESG pay-link.\textsuperscript{xii} One study of firms on major European indexes found that 68% apply one or more ESG metrics in their executive incentive calculations.\textsuperscript{xi} Regulations and stakeholder activism are encouraging European companies to adopt ESG incentive plans faster than elsewhere.

In the United States and Canada, more than 13% of firms have an ESG pay-link. In the less prescriptive North American environment, companies do not have the same motivation to implement ESG incentive plans as in Europe. Nonetheless, leading U.S. and Canadian companies continue to move in this direction. And others will follow, especially as standards evolve and regulation advances. One 2021 survey of 100 top U.S. companies found 45% already use ESG pay-links, while another 15% are planning to do so.\textsuperscript{xiv}

\textbf{ESG Pay-Link Adoption by Region}

![ESG Pay-Link Adoption by Region](image)

\begin{itemize}
\item Europe: 17%
\item U.S. and Canada: 13%
\item Africa and Middle East: 11%
\item Asia-Pacific: 4%
\item Latin America and Caribbean: 3%
\end{itemize}

\textbf{Figure 1*} | Source: Sustainalytics | For Informational Purposes Only

\“The relatively high prevalence of ESG pay-links among European issuers may be explained by the presence of an active community of institutional investors coupled with a long tradition of say-on-pay votes.\”\textsuperscript{*}

– Martin Wennerström, Sustainalytics ESG Research Senior Manager, Corporate Governance
Interestingly, the use of short-term ESG incentives (STIs) is 12% for both Europe and the U.S. and Canada, while long-term ESG incentives (LTIs) are used in Europe more than four times as often as U.S. and Canada. The typical time periods for STIs may be quarterly and annual, while LTIs are multi-year. Europe also stands out compared to U.S. and Canada when it comes to including both long and short-term ESG incentives in variable compensation plans. European firms are three times as likely to have both STIs and LTIs.

Less than 4% of Asia-Pacific companies currently have an ESG incentive plan in place. However, almost 70% of firms in the region plan to introduce ESG measures into their long-term incentive plans over the next three years, while 61% plan to do the same with their short-term plans.

While Asia-Pacific is lagging in terms of ESG pay-link adoption, firms in the region are taking a more balanced approach to long and short-term ESG incentives than U.S. and Canada. Asia-Pacific has one LTI for every three STIs, where U.S. and Canada has one for every six.

**Figure 2** | Source: Sustainalytics | For Informational Purposes Only
Companies Looking for Guidance

Despite the growth in ESG incentive plans, many companies are still looking at how to adopt this incentive structure. Key challenges include clearly articulating material ESG issues (MEIs), ensuring the board understands them, deciding on appropriate KPIs, and measuring the success of ESG programs based on those metrics. Soon, firms and boards will be expected to have answers.

Although pressure to incorporate ESG into compensation still comes primarily from institutional investors and stakeholder groups, regulatory agencies that are developing ESG reporting requirements have also begun to consider this practice.

Regulatory Environment Taking Shape

The regulatory environment around ESG reporting is highly dynamic, and there are multiple efforts from government, industry, and professional bodies around the world to establish ESG reporting standards for disclosure, measurement, remuneration, and so on. These are some of the most important recent regulatory and best practice developments that specifically address ESG performance-based compensation.

• **The Investment Association (U.K.):** This body, which represents British investment managers overseeing GBP 9.4 trillion (USD 11.4 trillion) in assets, released a document titled, *The Principles of Remuneration*, which includes guidance on how to develop ESG-linked bonuses and compensation schemes.

• **The Shareholder Rights Directive II (EU):** These say-on-pay provisions provide shareholders with a right to vote on remuneration policy and reports. The updated directive requires numerous additional European countries to regulate shareholders’ right to vote on executive board pay. Many more companies that have ESG pay-links must now disclose their plans.xvi

• **U.S. Tax Code:** Amendments to tax laws governing performance-based compensation eliminated the exemption that allowed companies to rely on qualitative metrics. This change enables firms to increase bonuses with assessments of a company’s commitment to ESG principles.

• **Reporting Frameworks:** Although there isn’t yet a single consensus standard, a growing number of ESG-oriented reporting frameworks are now available to guide voluntary disclosure. These include the [Global Reporting Initiative](#) (GRI), [Sustainability Accounting Standards Board](#), and the [Taskforce on Climate-Related Disclosure](#) (TCFD).
How Linking Executive Compensation to ESG Metrics Can Support Corporate Goals

As investor and stakeholder interest in ESG performance continues to surge, companies are looking for more ways to align their practices with sustainability goals and demonstrate their progress. Corporate policies that link ESG targets to executive performance have become a clear priority for investors. According to a 2021 survey, 63% of respondents indicated the lack of performance hurdles for executives as "most important" when deciding to vote against a remuneration related proposal. xvii

Four Key Reasons Companies Are Implementing ESG Incentive Plans

Pressure from investors and stakeholders isn’t the only reason to tie executive compensation to ESG metrics. Sustainalytics’ data indicates that companies across industries and around the world are incorporating ESG performance into incentive plans. These are some of the reasons companies like yours are using ESG pay-links.

Reason One: Alignment With Corporate Vision

Linking pay to ESG performance focuses executives’ attention on non-financial topics that are important to your corporate strategy. By going through the process of choosing material ESG issues and setting credible targets, companies and their boards and executives can gain immense insight into how to effectively meet strategic priorities.

“Boards that tie executive compensation to ESG metrics are using one of the most powerful tools they have to make real progress on ESG goals, and at the same time signaling the strength of their commitment to these issues.” xix

- SEC Commissioner Allison Herren Lee
Reason Two: Accountability

Tying variable compensation to ESG performance also provides an additional tool for firms and boards to hold their executives to account, while communicating their principles and objectives to employees, investors, regulators, and other important stakeholders. This is especially important when it comes to companies in high ESG risk industries, which may have more difficult MEIs to address.

Reason Three: Enhanced Financial Performance

There’s mounting evidence that ESG-integrated portfolios provide better financial returns than benchmarks, plus improved risk management. One 2020 survey found that 43% of investors believe applying ESG criteria to corporate decision-making leads to enhanced financial results, an increase of 14% over 2019. ESG management principles may also improve financial performance by bolstering brand value and goodwill, reducing turnover and associated costs, attracting talent, and tapping into new business opportunities and strategies that are linked to ESG initiatives.

Reason Four: Advancing Diversity, Equity, and Inclusion

Large firms that have instituted ESG-linked executive compensation policies are using this approach to address social justice concerns, such as improving racial diversity. Fortune 500 companies like Starbucks, McDonald’s, and Nike have pledged to use workforce inclusion KPIs as a metric to evaluate executive compensation.

Spotlight on Transparency

Executive compensation has received increasing scrutiny in recent years from investors, shareholder activists, and social justice organizations. Given the focus on transparency within both corporate governance in particular and ESG in general, companies should extend this principle to policies that link ESG programs to their executive compensation formula. When companies incorporate ESG into incentive plans, their boards, investors, employees, communities, and other stakeholders have a valuable tool to track their progress on ESG issues.

“Transparency is a key consideration when evaluating the degree to which ESG pay-links can be expected to incentivize executives to pursue an ESG agenda,” according to a 2020 Sustainalytics study on executive remuneration and ESG metrics by Martin Vezér and Martin Wennerström.

Sustainalytics’ Corporate Governance research team defines an ESG pay-link as transparent when the incentive includes specific, pre-set sustainability-related performance metrics. “Specific” means it relates to a measurable ESG indicator. “Pre-set” means there is sufficient disclosure to determine the correspondence between performance and payout.

With the increased scrutiny – and the risk of greenwashing claims – companies have little to gain from taking shortcuts with their incentive plans and will likely need expert help to confirm the validity of their indicators and overall compensation plans. According to Vezér and Wennerström, “Although ESG pay-links face many of the same challenges of transparency and verifiability as their traditional financial counterparts, these concerns are often more pronounced for ESG pay-links, which tend to lack clearly operationalized metrics.”
Preparing to Meet the Challenges of Establishing Pay-Links

Of course, there are challenges to linking executive incentives to ESG metrics. But companies that take their ESG pay-link plans seriously should not find the obstacles insurmountable. This practice is still relatively new, but there is some formal guidance for companies on setting up and managing certain aspects of an ESG incentive program (see page 8 – Regulatory Environment Taking Shape). Nonetheless, given the novelty and the challenges outlined here, firms seeking to add credible ESG metrics to their executive compensation plans should expect to consult with third-party ESG experts.

Establishing Credibility

One of the most important challenges firms face when tying executive compensation to ESG metrics is structuring these incentive programs so they are credible. In general, a credible and effective ESG-pay-link program involves multiple elements, including a clear articulation of material ESG issues; solid board engagement and buy-in; the selection of appropriate metrics supported by operational data; and the means of measuring success.

The central aspect of a credible ESG pay-link is tracking appropriate performance indicators that measure issues that are material to your business and support your corporate strategy. To ensure credibility, teams or committees tasked with executing an ESG incentive program must make sure they apply the same care in measuring the KPIs as with financial metrics.
Prioritizing Long-Term Over Short-Term Thinking

Another challenge involves incorporating ESG metrics into the full spectrum of incentives for executives. Short-term or annual ESG incentives are generally more common than long-term ones, and companies clearly believe short-term targets have their place in bonus plans. Of the companies that have an ESG pay-link, more than 80% have short-term ESG incentive plans, compared to 33% with long-term ESG incentives, while around 14% offer both.xxxiv

Companies looking to achieve progress on core strategic priorities need to avoid short-term thinking and incentivize top leadership to think long-term. Compensation committees and leaders may have to overcome resistance due to entrenched attitudes and concerns about effectiveness.

Engaging in Stakeholder Communication

Companies need to understand how to respond to input from stakeholders (e.g., regulators, lenders, activist investors, etc.) and transform that messaging into a compensation program that addresses ESG-related strategic goals.

Establishing Proper Resourcing

As with ESG more broadly, any effort to link ESG KPIs to compensation must have a champion on the board or in the C-suite, and will then require a dedicated team working alongside outside advisors to formulate a properly resourced action plan.
Companies thinking about adopting ESG-linked executive compensation need to carefully consider the structure of these incentive packages, the process for developing them, and a method for determining whether the program is producing the desired results. It may sound like a lot of effort and complexity, but there’s a good chance your organization already has a similar incentive program for financial and operational targets. The main difference will be in choosing the appropriate metrics.

In general, compensation committees should keep in mind the following best practices. The ESG incentive should be:

• Measured against material ESG issues that address long-term strategic priorities.

• Clear enough that the board, executives, and stakeholders understand the connection between the metric and the reward.

• Applied with the same due diligence used for financial and operational KPIs.

For example, climate transition is a long-term issue and firms with climate as a material ESG issue can prepare by linking executives’ long-term incentive plans to reduced carbon emissions. No matter what industry your company is in, an ESG pay-link can help incentivize your executives to pursue strategic ESG goals.
How Three Industry Leaders Are Implementing ESG-Based Incentives

Apple

In advance of its 2021 annual general meeting, the company informed shareholders that annual bonus payments would be increased or decreased by 10% based on KPIs relating to Apple’s ESG program:

“We manage Apple for the long term. Consistent with this approach, beginning in 2021, an ESG modifier based on Apple’s values and other key community initiatives has been incorporated into our annual cash incentive program. This change is intended to further motivate Apple’s executive team to meet exceptionally high standards of values-driven leadership in addition to delivering strong financial results.” - Apple 2021 Environmental Social Governance Report

As of 2021, Apple includes a bonus modifier of up to 10% if the company meets its ESG targets, and a failure to meet those goals could result in a bonus reduction of the same amount. Apple is a leader in the technology industry as less than one percent of tech companies in Sustainalytics’ corporate governance research universe have adopted ESG pay-links.

Mastercard International

Mastercard is another example of a company in an industry where few are adopting ESG pay-links. Only three percent of software and service firms have them. In 2021, Mastercard International introduced the use of ESG metrics in determining executive compensation for executive vice presidents and above, focusing on the company’s three priorities: carbon neutrality, financial inclusion, and gender pay parity. “The purpose of our incentive compensation programs is to encourage and reward performance that helps us achieve our goals — financial goals, of course, as well as strategic goals that lay the foundation for our future success,” the company explained. In 2022, Mastercard extended the measure to all employee bonuses.

As of 2021, Mastercard will increase or decrease payouts for executives by up to 10 percentage points based on performance against quantitative goals: carbon neutrality (100% offset of operational CO2 emissions), financial inclusion (target based on additional participants in the digital economy), and gender median pay gap.

Siemens

Between 30% and 42% of the total target compensation for Siemens’ executives comes in the form of stock awards, which are variable in value and long-term in scope. The company calculates the amount based on a formula that includes 20% for annual ESG performance. This performance is assessed on the basis of a proprietary sustainability index.
Executing on an Action Plan

Understand the Context

For firms embarking on this journey, the first step is to understand the context. The committee or team in charge of developing and implementing the incentive plan should understand the problem that the plan is intended to solve. Is it an operational risk you’re seeking to mitigate, pressure from investors or other stakeholders, or something else? Only when you clearly understand the problem, can you determine whether an ESG incentive plan is an appropriate way to address the issue and if there are better ways to solve the problem.

Other early questions you will want to ask include: Do you have the resources to effectively implement such a program? The engagement to maintain it? Who will be involved?

Companies need a clear-eyed look at their reasons for starting an ESG incentive plan for executives. If the board and C-suite don’t plainly understand the need or properly support the program, companies risk poor implementation, procedural failures, and reputational damage. Not to mention, a poorly executed plan will not likely provide the desired outcome.

Making Decisions on Material Issues

When your company decides to move ahead with an ESG pay-link, you’ll need to select the appropriate material ESG issues to base the incentive on. The process should include shareholders and incorporate their feedback in identifying the best metrics to use when linking compensation to ESG. As we’ve mentioned, for an effective and credible ESG incentive, companies should choose to address issues that are important to their purpose. This is generally a good time to contact an ESG expert that can provide insight into the MEIs that are most important to your business.
Setting Goals and Targets

You should know by this point what it is you want to accomplish broadly, but now you need to determine what specific targets will help you reach that goal. There should be a clear connection between what you are measuring and your corporate strategy. Companies should engage with the board, investors, and other stakeholders to ensure they can easily understand how an executive’s actions affect performance on a particular MEI. It may be a good idea to run a trial program for a year to familiarize everyone with the process and develop a performance baseline.

Structuring the Plan

These questions should help firms understand what the incentive plan will look like. These issues will be familiar to any firm that already has an executive variable compensation plan.

**What is the incentive?** Companies should identify the type of compensation to be linked to ESG targets (e.g., bonus, stock grants) and a multiplier to establish the specific figure.

**Who does it apply to?** These incentives typically apply to C-suite executives, but have been extended to executive vice-presidents and, in some cases, are now used to establish bonuses more broadly across a company.

**Is it short term or long term?** Most ESG-linked compensation schemes are tied to short term goals, e.g., annual bonuses based on corporate progress towards its ESG targets. To effectively engage executives in their ESG performance goals, it is crucial to include long-term targets as well.

**Incorporate the targets and strategic priorities.** The compensation metrics must derive from specific ESG targets, which in turn reflect the company’s broader ESG goals; e.g., net zero by 2040, or gender parity in the C-suite by 2030.

It is essential to record this process in order to transparently disclose to stakeholders why and how you chose the goals, MEIs, and targets, and structured the incentive.
In response to investor pressure, increased awareness of ESG issues, and the prospect of regulation, interest in linking compensation to ESG performance has expanded beyond trendsetting multinationals to much broader swaths of the universe of publicly traded companies. Europe is the leader by far, but activity in North America is increasing. Asia still lags, but many forward-looking boards considering the evolution of their ESG programs are planning to introduce ESG pay-links. Some are aiming to lead their industries.

The proliferation of companies that now tie executive compensation to ESG metrics means that the market is generating norms, standards, and performance data. Firms now planning to take this step can start to understand the issue by learning from peer-company experience, and advancing their knowledge with expert advice from outside consultants.

For decades, companies have structured their compensation packages to ensure that the incentives provided to individual executives align with broad corporate strategic priorities; gain a deeper understanding of the material ESG issues they face; build trust with investors, employees, and other stakeholders; enhance their transparency; and be well prepared for disclosure regulations.

Conclusion: Accountability, Transparency, Strategic Value
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ESG pay-link refers to how a company factors ESG criteria into executive variable remuneration plans. A transparent ESG pay-link includes specific, pre-set sustainability-related performance metrics.


As of 2022, in Sustainalytics' Corporate Governance Ratings universe of 4449 companies, 10% have a transparent ESG pay-link.

Data on pay-link adoption in Africa, the Middle East, Latin America, and the Caribbean is limited compared to other regions.

Sustainalytics' proprietary data.

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