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Linking executive pay to ESG goals

Public pressure and changing norms are paving the way for business leaders to be paid based on a new set of criteria.

BY PHILLIPPA O'CONNOR, LAWRENCE HARRIS,
AND TOM GOSLING

Phillippa O'Connor
phillippa.o.connor@pwc.com
is the national leader of the reward and employment practice at PwC UK and a specialist in executive pay. Based in London, she is a partner with PwC UK.

Lawrence Harris
lawrence.s.harris@pwc.com
is an executive pay and workforce specialist with a focus on aligning people to ESG and sustainability. Based in London, he is a senior manager with PwC UK.

Tom Gosling
tom@tom-gosling.com
is an executive fellow in the department of finance at London Business School contributing to the evidence-based practice of responsible business. Based in London, he was formerly a partner with PwC UK working on executive pay.

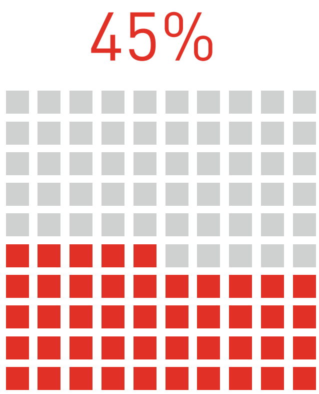
The corporate world is responding to the rising pressure to embrace the concept of doing well by doing good—and the expectations continue to increase. Sustainability achievements are now routinely acknowledged alongside traditional key performance indicators (KPIs). This may in part be to burnish reputations, but there's increasing evidence in the academic literature that sustainability has a positive impact on the bottom line and shareholder value. Today, nearly half of the FTSE 100 companies set measurable environmental, social, and governance (ESG) targets for their CEOs, and have begun to introduce ESG targets in executive comp packages, and in a recent global survey by Willis Towers Watson, more than three-quarters of board members and senior executives said strong ESG performance is a key contributor to financial performance.

By now it's safe to say that to remain competitive, relevant, and respected—externally and internally—a public company, regardless of sector, must establish an ESG agenda too. As one example, remuneration may become a litmus test for financial regulators assessing whether banks, asset managers, and insurers are taking climate change seriously enough.

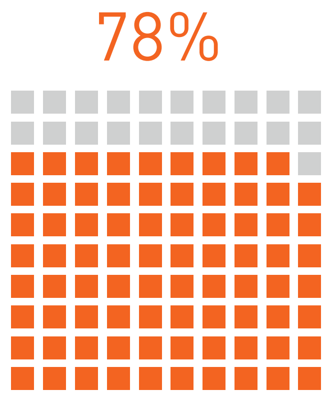
Including ESG metrics in executive pay packages is a tangible way to close the say–do gap for a skeptical audience, but is not without its challenges. There's a risk of hitting the target but missing the point. An example might be a bank that focuses on reducing its own carbon footprint when the biggest effect it could have on reducing emissions is through changing its approach to financing companies that emit carbon. There's a risk of distorting incentives. Research shows that incentivizing pro-social goals can undermine intrinsic motivation, as

ESG as performance motivator

Financial incentives can help drive the ESG agenda.



of FTSE 100 companies now have an **ESG measure in executive pay**



of board members and senior executives agree that **strong ESG performance** contributes to organizational value and/or financial performance

Source: PwC and London Business School, *Paying well by paying for good*, 2021; Willis Tower Watson, *ESG and Executive Compensation*, 2020, a survey of 168 board members and senior executives, © 2020 Willis Towers Watson, used with permission

reported in the *Journal of Economic Perspectives.* Or focusing on a narrow aspect of an ESG issue (e.g., board diversity) may distract from the broader objective (an inclusive culture).

And finally there's a risk in calibration. Companies tend to set strategic targets that they will hit, which is why meeting them pays out ten to 15 percentage points higher on average than meeting more objective financial metrics. There's often an idea that ESG targets in pay can be used to direct CEOs to undertake activities that benefit society, which they wouldn't undertake without the incentive. This misunderstands how board governance works. Pay follows strategy; it doesn't drive strategy. But once ESG factors are integrated into the strategy, linking them to pay can be a natural next step, particularly as a tool for mobilizing the organization behind a new set of priorities.

Below, we will look at four key dimensions that remuneration committees need to weigh up when they decide how to help: internal and external targets, how to keep track of and measure progress toward those goals, what time frames to use, and how to determine success. First, a bit of history.

The evolution of ESG

Decades ago, companies began implementing internal initiatives to boost ideals such as quality and safety, health and wellness, recycling, energy conservation, and community service. That morphed into corporate social responsibility, or CSR, which added environmental sustainability, ethics, and equity—principally, gender equity and diversity goals—into defining good citizenry among businesses. CSR programs ultimately produced demonstrable gains in customer loyalty, employee engagement, and earnings performance: doing good proved to be good for business. But these gains were not linked explicitly to pay, perhaps because they were just so hard to measure.

That's changing. The plethora of metrics around ESG are standardizing, investors are demanding more transparency, and regulators are beginning to get in on the act. The World Economic Forum, in coordination with the Big Four accounting firms, published guidance on internationally agreed-upon metrics for tracking and disclosing short- and long-term ESG goals and targets. In 2019, the CEOs of 181 publicly owned US companies signed on to the Business Roundtable's revised Statement on the Purpose of a Corporation, committing to deliver value to all stakeholders, not just shareholders. The signees vowed to protect the environment by embracing sustainable practices, foster diversity and inclusion (D&I) among employees, and commit to transparency and effective engagement with shareholders.

In April 2021, the European Union formalized ESG reporting requirements for both asset managers and medium-to-large businesses. The US Securities and Exchange Commission (SEC) has noted the increase in investor demand for company disclosures on climate-related risks, board and leadership diversity, and political donations. The SEC recently created a Climate and ESG Task Force to proactively identify ESG-related misconduct. The UK's Prudential Regulatory Authority (PRA) wrote to CEOs to stress the importance of incorporating climate risk throughout their business models and governance. To put some muscle behind that advice, the British government has made the detailed reporting of climate risk mandatory for most publicly traded companies and financial firms.

The four dimensions of ESG remuneration

Choosing ESG measures for pay, and calibrating them properly, requires boards to bring together insights from operational teams, the sustainability function, and finance, and to look at the future through an unconventional and sometimes uncomfortable lens. And it requires the company to understand its purpose and the practicalities of adding ESG to pay metrics. Many companies are squaring up to figure this out.

Big names—including Apple, McDonald's, Rio Tinto, Royal Dutch Shell, and Unilever—have announced linking ESG to executive pay. Apple introduced a modifier to executives' bonus payouts, adjusting them by up to 10% based on performance with respect to "Apple Values," including accessibility, education, environment, D&I, privacy, and supplier responsibility. Shell, which in 2018 became the first oil major to link ESG to pay, in 2021 increased the weighting of the long-term targets around reducing its net carbon footprint to 20% from 10%. Melbourne-based Rio Tinto recently announced plans to realign its short-term incentive plan (STIP) by reducing the individual performance component to 15% from 30%, and allocating the resulting 15% to ESG. Together with the 20% already allocated for safety, 35% of the company's STIP now covers broader ESG metrics. Increasing numbers of investors are pushing for inclusion of ESG targets too.

Here are four key design dimensions that leaders and their remuneration committees need to keep in mind when they include ESG measures as part of pay.

Internal and external targets. Input measures are internal targets that the company uses to benchmark itself, such as developments in diversity initiatives or investments in green technology. They are measured by activities that lead toward a stakeholder outcome, not by the outcome itself. Output measures are external targets based on measures of stakeholder impact, such as the total amount of emissions produced or employee engagement scores. Both types of measure are valid, but both need to be aligned to the company's strategic priorities, and the company needs to be able to collect, analyze, and communicate the data needed to support assessing whether targets have been met. Given the potential lack of objectivity with input measures, we see increasing investor pressure for output-focused rewards.

For example, 20% of Royal Dutch Shell's long-term incentive plan (LTIP) is an energy transition measure that includes both input and output goals. The input measure is focused on reducing the carbon used in the business, increasing the use of biofuels and developing carbon-capture technology. The output measure assesses three-year performance against a net carbon-reduction target.

Individual KPIs and scorecards. It's important to keep track of and measure progress toward ESG goals. Sometimes a company will have one or two critical ESG issues that tower above the others—such as a net-zero commitment—with a few essential KPIs. But a multidimensional approach to ESG that includes diversity and inclusion, employee welfare, supply chain issues, environmental impact, and so on will need a carefully constructed and transparently disclosed scorecard to keep track of benchmarks and targets. There's a balance to strike between the scorecard being sufficiently comprehensive to capture the range of ESG priorities and becoming so complex as to be unmanageable.

An example of how this works in practice is Unilever's sustainable living plan, which encapsulates a scorecard of sustainability priorities that have been in use for more than a decade. This scorecard is weighted at 25% of the LTIP plan.

LTIP and annual bonus. Will a short- or long-term time frame be most effective? Environmental goals sit comfortably within the LTIP because of their long-term orientation. But some ESG targets, such as health and safety goals and even gender pay targets, can be robustly calibrated over a single year. It is better to set ambitious, well-calibrated one-year targets than vague long-term ones. Specifics matter when creating the remunerative narrative that goes before shareholders and all stakeholders. Our study of the FTSE 100 companies found that 55% of ESG measures related to pay were tied to bonuses and 50% were linked to LTIP.

For example, BP uses ESG measures in both its annual bonus and its LTIP. Starting in 2020, the bonus has a 15% weighting on safety (which has well-established metrics) and on environment, which relates to short-term emissions reduction targets. The LTIP now has a 40% weighting to strategic goals, including input measures around renewables, the energy transition, and car electrification.

Underpins and scale targets. Identifying how to determine success will be critical. Some metrics will be considered "table stakes" and a gateway to bonuses rather than a stretch target. Health and safety metrics in businesses such as mining and healthcare might be one example. In such cases, failure to meet expected standards might be cause for bonus reductions as opposed to a route to accruing additional rewards. But in other cases, performance scales will need to be established for ESG targets. This is particularly true for transformational objectives, such as emissions reductions.

For example, BT, the UK telecoms company, operates a restricted share plan with two underpins, one of which is that there should be no ESG "issues resulting in material reputational damage." Another example is asset manager Legal & General Investment Management; it is one of several shareholders that have expressed a specific preference for underpins of minimum ESG targets.

Boards and remuneration committees need to become familiar with all these dimensions and understand how executive pay is aligned with the company's stated purpose, which stakeholders will benefit, and why. In the process, they will have to clarify the reasons for linking compensation to ESG targets, including the benefits of achieving certain ESG goals and the ineffectiveness of existing or alternative incentives. And, at the same time, they must ensure that inherent risks have been considered and mitigated.

The corporate world is at a crossroads, where companies and leaders are debating their fiduciary responsibilities, while society is demanding that businesses be held accountable to a wide constituency. Establishing and achieving ESG goals drives value and is often simply the right thing to do. Connecting those goals more closely with executive pay seems an obvious next step. We'll certainly see more of it. But it needs to be done with care and thought, as it's difficult to do well. +

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