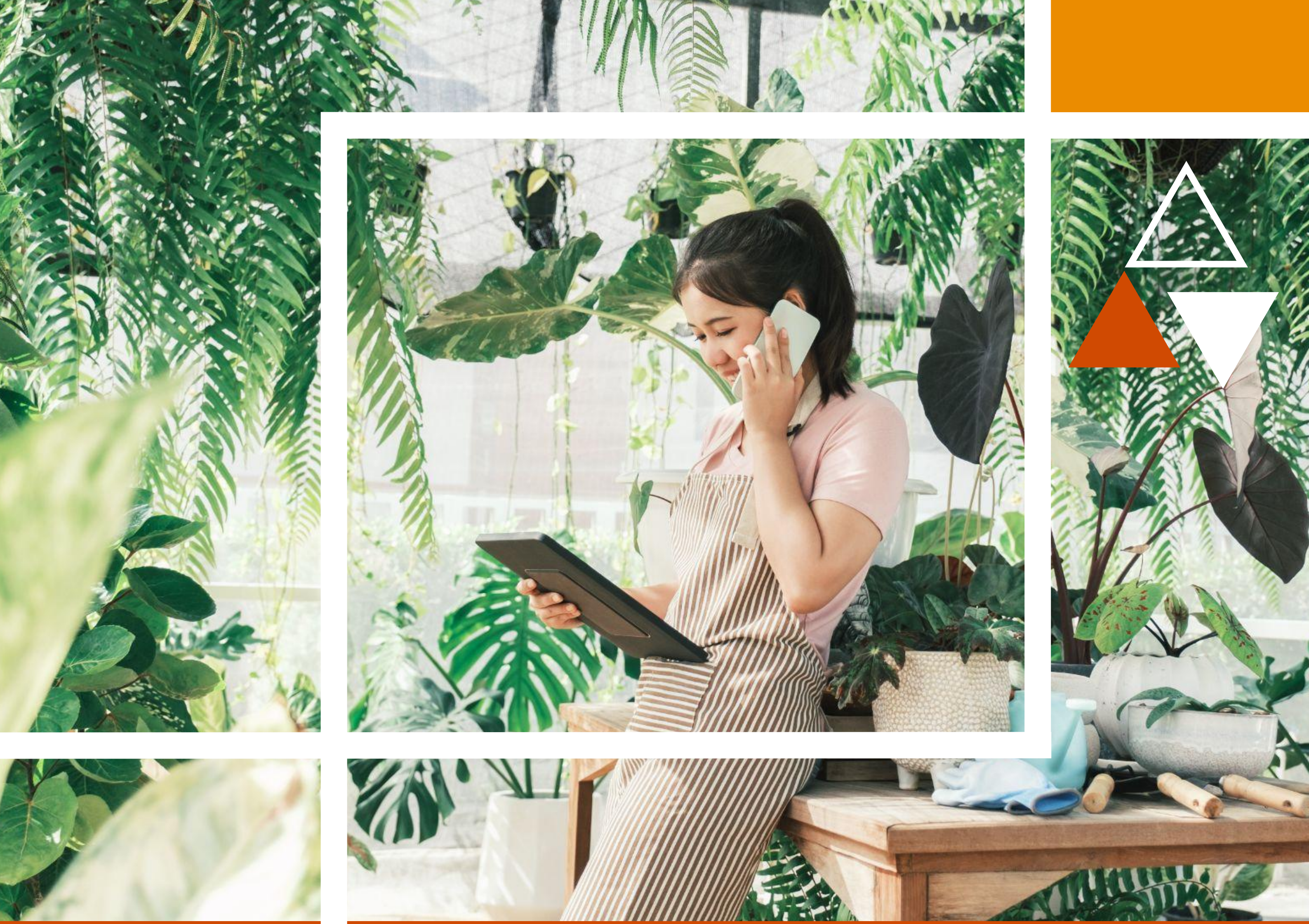

ESG-driven remuneration

Enhancing sustainability in the asset and wealth management industry

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pwc

Contents

Introduction

The subject of executive pay and remuneration has long been an area of contention, with a plethora of examples of packages deemed "excessive", whether by shareholders or activists, permeating the landscape.

Indeed, an often cited talking point, particularly among those of a more activist nature, is the 1,209% increase in executive position compensation of chief executive officers (CEOs) in the years since 1978 up to 2022, whereas pay for those lower down the corporate ladder for the typical worker has only increased 15.3% in the same period, barely keeping up with inflation[1].

The topic of environment, social and governance (ESG) and sustainability has emerged as another such 'lightning-rod' issue which has gained increased visibility and prominence in corporate and social circles in recent years, often with increasingly partisan rhetoric to accompany it.

With growing numbers of companies examining the role of ESG and sustainability in their daily operations and corporate strategy, it stands to reason that the ability to deliver on ESG commitments may start to have a larger bearing on executive remuneration, and the failure to deliver on ESG commitments should have an adverse impact on said remuneration.

Based on the most recent industry survey conducted by PwC Singapore[2], the asset and wealth management (AWM) sector is favourable in this regard, with 38% of asset managers linking some aspect of their remuneration to ESG key performance indicators (KPIs) but generally, more could be done.

Of those who link remuneration to ESG targets, the majority incorporate ESG performance within short-term incentive plans but only 30% have both short- and long-term incentive plans. A large number (64%) of ESG-linked remuneration frameworks only apply to the board and senior management (BSM) members, with the remaining 36% having similar structures for other functions in their organisation. Environmental factors are prioritised by 39% of respondents, followed by Social and Governance with 31%. More than half (53%) of respondents include qualitative ESG factors and metrics within their incentive plans.

As ESG assets under management (AUM) is forecasted to reach USD 33.9 trillion by 2026[3], it is apparent that increasing ranks of investment managers across both public and private markets are incorporating ESG and sustainability into their investment practices, whether due to outside pressure or to align with internal beliefs, and that this is an area likely to receive increased attention in the coming years.

This attention will likely not just be from shareholders of investment entities, but those on whose behalf they invest, regulators and policymakers, and other industry stakeholders.

As it stands, asset managers who do incorporate ESG KPIs into their remuneration frameworks appear to do so on an ad hoc basis, creating their own models and metrics to apply.

Whilst this may lead to a greater range and more relevant KPIs to measure against, the methods for setting targets and calibrating them are often untested, and best practices remain scarce[4]. The questions remain of what to measure and how to measure; and the longer there is a lack of industry agreement around these, the greater the likelihood that regulators, either at a global or national level, will take the decision upon themselves to answer them.

This digest will examine the drivers behind integration of ESG KPIs into executive remuneration within the AWM industry; the ways in which remuneration can be linked to ESG for asset managers investing in public and private market assets; specific case studies where ESG integration to remuneration KPIs has been or is being implemented in Asia Pacific and; how this compares to Europe. It also delves into the challenges faced when linking remuneration to ESG KPIs.

1. CEO pay slightly declined in 2022 (2022), Economic Policy Institute
2. PwC environmental risk management and ESG survey for banks and asset managers (2023), PwC Singapore
3. ESG-focused institutional investment seen soaring 84% to US$33.9 trillion in 2026, making up 21.5% of assets under management: PwC report (2022), PwC United States
4. Linking Executive Pay to Sustainability Goals (2023), Harvard Business Review

Drivers behind the trend

ESG-linked executive incentives are deemed to serve as a mechanism amongst investors and other stakeholders to create accountability for actions that are aligned with corporate goals and supporting targets. There are numerous factors that drive financial institutions' decisions to link ESG KPIs to executive remuneration.

These include external factors such as media pressure and reputation management / enhancement, the desire to attract new capital and investment, the ESG and sustainability criteria of investors when deciding whether to invest or not, government and regulatory requirements, and others.

An article from Stanford Business School revealed that institutional investors are more inclined to increase their holdings in firms that implement ESG incentives for executive compensation[5]. The article suggests that investors may prioritise concerns such as climate change, workplace diversity and pay equity. Additionally, they may believe that robust environmental practices and social responsibility contribute to long term economic sustainability.

Internal factors also exist. An entity may have a genuine desire to be, what they consider, a force for good in the world, staff and leadership may wish their organisation to incorporate ESG aspects into the corporate DNA, it may be to provide a more attractive working environment for talent, or a myriad of other factors and forces.

With growing emphasis on aligning business practices with the principle of doing well by doing good, expectations are on the rise. Sustainability achievements are now regularly recognised alongside traditional KPIs. While some may view this integration as a means to enhance reputations, academic literature increasingly provides evidence that sustainability positively influences the bottom line and shareholder value[6]. According to 2022 Chartered Financial Analyst (CFA) Institute's regional analysis of the Asia Pacific region, respondents stated high frequency of ESG issues impacting share prices. Specifically, 73% (up from 64% in 2017) of respondents stated that governance issues often or always affect share prices, while 55% (up from 30% in 2017) mentioned social issues and 59% (up from 24% in 2017) mentioned environmental issues as having a similar impact[7].

Increasingly, external pressure from asset managers and other institutional investors has been applied to companies, with several making well-publicised announcements regarding voting on board resolutions, board composition, and other factors. The same article from Stanford Business School also indicated that companies engaged by large asset managers such as Vanguard, BlackRock and State Street are more likely to embrace ESG pay structures[5].

5. Does It Pay to Link Executive Compensation to ESG Goals? (2023), Stanford Business School of Graduate
6. Linking executive pay to ESG goals (2021), PwC United Kingdom
7. ESG Integration in Asia Pacific: Markets, Practices, and Data (2022), Chartered Financial Analyst

Drivers behind the trend

BlackRock, the world's largest investment manager by AUM, is a prime example of this, exerting influence over boards of directors of companies it holds stakes in, either pushing them to make positive ESG and sustainable decisions or voting against resolutions should the board not have the composition that BlackRock deems ideal[8].

In 2020, BlackRock CEO Larry Fink stated that they had identified 244 companies that were making insufficient progress integrating climate risk into their business models or disclosures, then proceeded to take voting action against 53 of these companies, and, noting that the remaining 191 were 'on watch', stated that if they did not make significant progress they would risk voting action against management in 2021.

BlackRock and Mr. Fink have recently toned down their rhetoric in this regard, removing references to ESG and stopping the use of the term ESG due to its "weaponised" nature[9]. Despite this, BlackRock's stance on ESG has remained unchanged and it will likely continue to espouse and implement.

Locally, financial institutions such as OCBC, DBS, and UOB have taken action in 2019, halting lending towards coal and fossil fuel projects and other investments which are categorised as unsustainable and non-environmentally friendly[10].

In the wider asset management space in Singapore, increasing numbers of investment managers are establishing ESG Centres of Excellence in the city-state, contributing to growing products, knowledge, and standards within the ESG and sustainability space. In time, these centres may well help to drive and clarify the linking of ESG KPIs to remuneration[11].

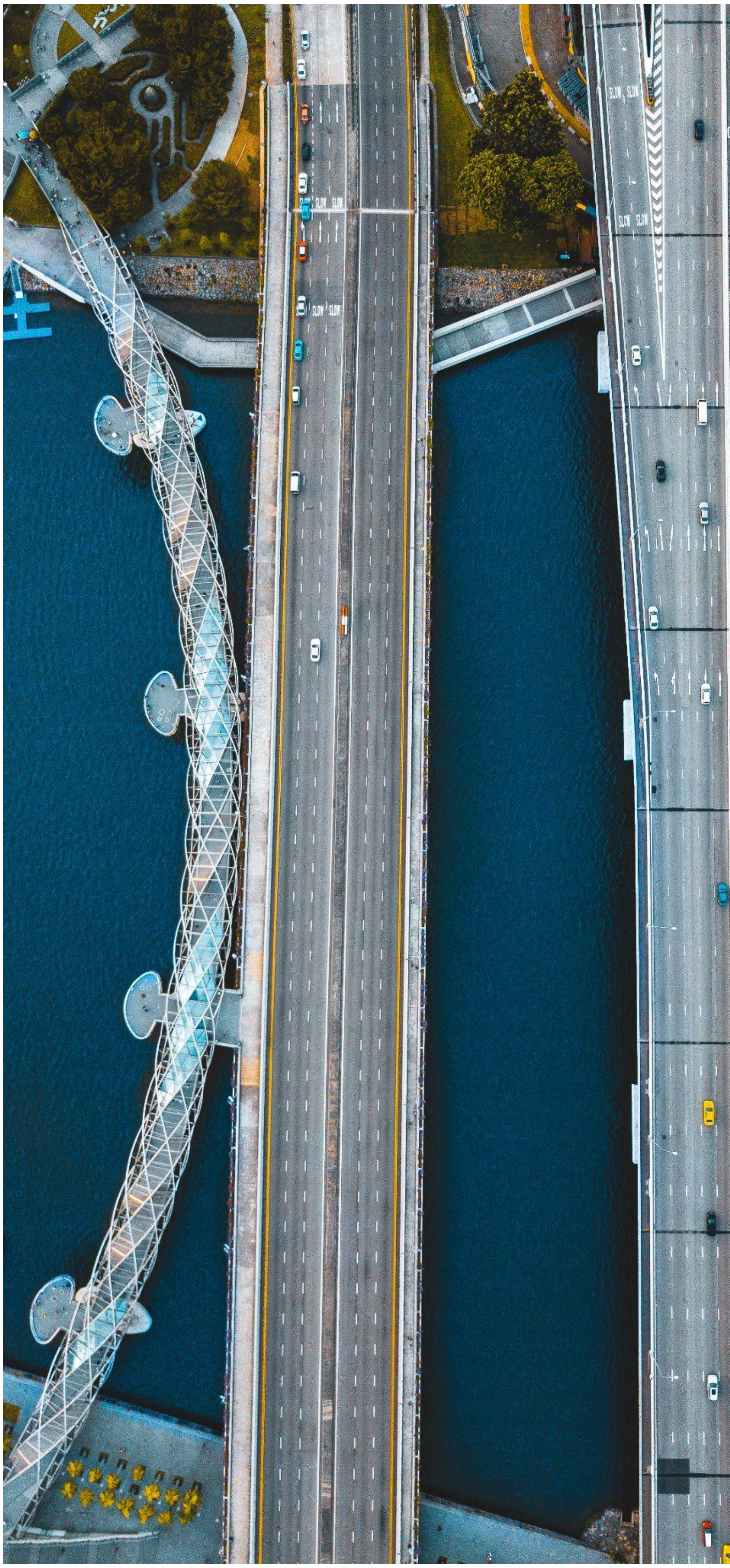
With a confluence of factors, both top-down and bottom-up forces and external and internal driving ESG adoption within organisations, it stands to reason that executives charged with implementing the strategy and driving economic and social value for shareholders and other stakeholders, should be financially rewarded for their achievements in this regard, or financially punished should they fail to deliver.

Such measures have seen substantial adoption by the corporate sector, with circa 50% of FTSE 100 companies implementing ESG measures in executive compensation, and 78% of board members and senior executives agreeing that strong ESG performance contributed to organisational value and financial performance as of mid-2021[12].

8. BlackRock's tyrannical ESG agenda: Is Larry Fink a threat to democracy? (2023), UnHerd
9. BlackRock's Fink says he's stopped using 'weaponised' term ESG (2023), Reuters
10. Singapore banks caught in grey area as regional financial sector moves to OK coal phase-out (2023), The Business Times
11. Asia Pacific Centre for Sustainability Excellence, PwC Singapore
12. Linking Executive Compensation to ESG Performance (2022), Harvard Law School Forum on Corporate Governance

Exploring ESG remuneration disclosures among asset managers

Asset managers investing in public markets



Asset managers, especially those active in public markets, serve as a lynchpin for the implementation, adoption, and administration of ESG and sustainability principles across the financial sector.

As product manufacturers, they can create ESG funds. As institutional investors, they can direct substantial amounts of investment towards relevant sectors and companies. As managers of retail investors' retirement funds and other monies, they are, usually, prominent investors in public companies, able to exert substantial pressure on boards of directors and CEOs via the voting rights afforded them as such an investor.

Accordingly, their influence extends across both their external application of ESG KPIs when it comes to invested companies, and their own when setting executive compensation. With regards to the former, a survey conducted by ShareAction examining the governance and stewardship practices of the 77 largest global asset managers, which manage a combined USD 77 trillion in AUM across the Americas, Europe, and Asia Pacific, has concluded the following trends that were observed as at March 2023[13]:

- 82% of asset managers had voting policies on climate change, up from 56% in 2020.
- 81% voted on social issues, up from 53% in 2020.
- 88% publicly disclosed their voting records, up from 55% in 2020.
- 83% had implemented financial incentives pertaining to responsible investment, up from 7% in 2020.
- 69% of all decision makers received responsible investment training, up from 64% in 2020.

The survey noted that globally, asset managers had shown mixed results with regards to improving the policies pertaining to responsible investment and their disclosures of stewardship activities since the inaugural survey back in 2020, though demonstrable results in specific areas were clearly apparent.

Despite this improvement, key gaps in performance were identified, specifically regarding biodiversity voting and engagement policies.

13. Point of No Returns 2023 Part II: Stewardship and Governance (2023), ShareAction

Exploring ESG remuneration disclosures among asset managers

Geographic discrepancies also existed, with asset managers in Europe generally outperforming their peers in the Americas and Asia Pacific, especially with regards to stewardship where the top-10 firms were all based in either the U.K. or EU, though there were some dragging their heels in this regard as well.

One aspect that asset managers the world over seemed to be lacking in was linking executive remuneration to responsible investment, though, once again, U.K. and EU-based firms comprised the entirety of the top -10 in this regard.

Some examples of public asset managers and their implementation of ESG KPIs to remuneration policies are as follows.

1

Schroders

British asset manager Schroders specifically uses ESG metrics, along with financial KPIs, for measuring executive performance, with a focus on outcomes, rather than inputs, to potential corporate performance.

Regarding the application of KPIs and scorecards for executive remuneration[14], the avoidance of complex frameworks encompassing numerous measures is applied. This should have the practical effect of making the ESG KPIs executives need to meet easily understandable and accessible.

Further, Schroders has integrated the assessment of sustainability factors and risk across investment teams, assessing their performance, in part, in accordance with ESG-integrated investment processes[15].

2

Generali Group

The Italian financial conglomerate Generali recently implemented and updated various aspects of its remuneration policy to specifically encompass ESG, calling for internal ESG indicators, along with internal ESG ambitions which are aligned with the Group Strategic Plan, and the inclusion of increased disclosure regarding the description, measurability, and performance evaluation of the ESG KPI[16].

Such measures are now weighted 20% towards ones' variable remuneration component.

3

Amundi

French asset manager Amundi launched its ESG Strategic Plan on 8 December 2021, a strategic plan which its remuneration policy is aligned with, along with its Responsible Investment Policy[17].

Accordingly, implementation of the strategic plan accounts for 20% of the KPI's supporting the performance share plan among the top 200 executives of Amundi. Further, targets aligned with the Responsible Investing plan are set for all portfolio managers, sales representatives, and marketing teams.

14. Directors' remuneration policy (2023), Schroders
15. Remuneration framework (2022), Schroders
16. Report on remuneration policy and payments (2023), Generali Group
17. Amundi group remuneration policy (2024), Amundi Asset Management

Exploring ESG remuneration disclosures among asset managers

4

Abrdn

Abrdn's remuneration policy[18] has integrated sustainability considerations in their risk adjustment process where the determination of variable remuneration (at an aggregate and individual basis) incorporates sustainability risks. Furthermore, their policy supports its long-term strategy by reinforcing a performance-driven culture which aligns interests of employees, shareholders, clients, and customers. This long-term alignment is critical from a sustainability perspective and is achieved through deferral arrangements and the delivery of variable remuneration in shares and / or other instruments.

It is heartening to see from the above examples that several prominent, global asset managers and financial institutions have applied not only the ESG KPIs with respect to compensation and remuneration frameworks, but a range of metrics are being applied as well.

In time, this will hopefully allow for greater insight and consensus as to what metrics work and why. Within the aforementioned forecast of USD 33.9 trillion in ESG AUM by 2026[19], a best-case scenario will see circa USD 1 trillion of this flow to ETFs, the constituent companies of which will have public asset managers exert influence via their voting rights.

This influence will likely extend to voting on remuneration and ESG policies, as well as the linking of executive remuneration to meeting ESG KPIs. Ensuring that the remuneration of asset managers is linked in some capacity to meeting ESG KPIs, would only serve to gain them credibility in this regard.

Asset managers investing in private markets

Asset managers investing into private market assets, whilst generally not subject to as much public scrutiny and examination as their public market peers, nonetheless face many of the same pressures to implement and execute ESG and sustainability initiatives and practices in their operations and investments.

This pressure and scrutiny is largely applied from their Limited Partner (LP) investors, of whom, a reported 93% would walk away from a General Partner (GP) investment for matters related to ESG[20].

Said pressure is likely to only intensify in coming years, with 68% of LPs expecting to increase their ESG investment positions over the next few years.

Further, similar to their public market counterparts, many LPs and GPs seek to incorporate ESG and sustainability into their investments due to the morality of doing so or the value creation incentives such a move entails.

- 51% - Want to provide clear ESG communications to stakeholders
- 50% - See ESG as an additive to investment performance
- 34% - Want investments to make a positive impact

18. Our remuneration disclosure for the year ended 31 December 2022 (2022), Abrdn
19. ESG-focused institutional investment seen soaring 84% to US$33.9 trillion in 2026, making up 21.5% of assets under management: PwC report (2022), PwC United States
20. Limited Partners and Private Equity Firms Embrace ESG (2022), Bain & Company

Exploring ESG remuneration disclosures among asset managers

Several private asset managers have integrated ESG KPIs into their remuneration policies. The following outlines how they have implemented this integration.

01

EQT Partners

EQT's remuneration philosophy[21] ensures consistency and fairness in compensating employees, including the Executive Committee, across the entire organisation. It aligns compensation with EQT AB Group's business strategy, sustainability goals and long-term interests, emphasising long-term growth for shareholders. This ultimately incentivises behaviours and decisions that support sustainable growth and value creation over time.

02

Apollo Global Management

Apollo Global Management has pioneered an impact-aligned incentive structure[22], connecting a segment of its carried interest and management's equity compensation to impact objectives' performance. At each company, the performance of KPIs and the Business Impact Assessment (BIA) score at exit are evaluated against the targeted levels set at the investment stage to determine the extent of earned-impact-aligned incentives.

03

Macquarie Capital

Macquarie Capital's remuneration policy[23] is aligned with effective risk management, ensuring active monitoring of various risks which includes sustainability risks across all global business activities. Employees receive fixed remuneration, including base salary and local country benefits, reviewed annually to prevent undue risk-taking, while performance-based remuneration, determined through a company-wide profit share pool, considers business and individual contributions to profits, risk profiles, and adherence to conduct standards, with adjustments made for financial, non-financial, and sustainability risks as needed.

The United Nation Principles for Responsible Investment (PRI) has documented a significant uptick in private equity and venture capital managers aligning with its principles, marking a fourfold increase over the last five years, for a total of 1,090 signatories in 2022[24]. This clearly shows that more private market asset managers are slowly transitioning away from the mindset of only integrating ESG into their management unless they feel that it is aligned with the long-term profitability of the company.

21. EQT Annual and Sustainability Report 2022 (2022), EQT
22. Annual Sustainability Report (2022), Apollo Global Management
23. Principal Adverse Sustainability Impacts Statement and disclosures in relation to Sustainability Risks and Remuneration Policies (n.d), Macquarie Capital
24. Private Equity Should Take the Lead in Sustainability (2022), Harvard Business review

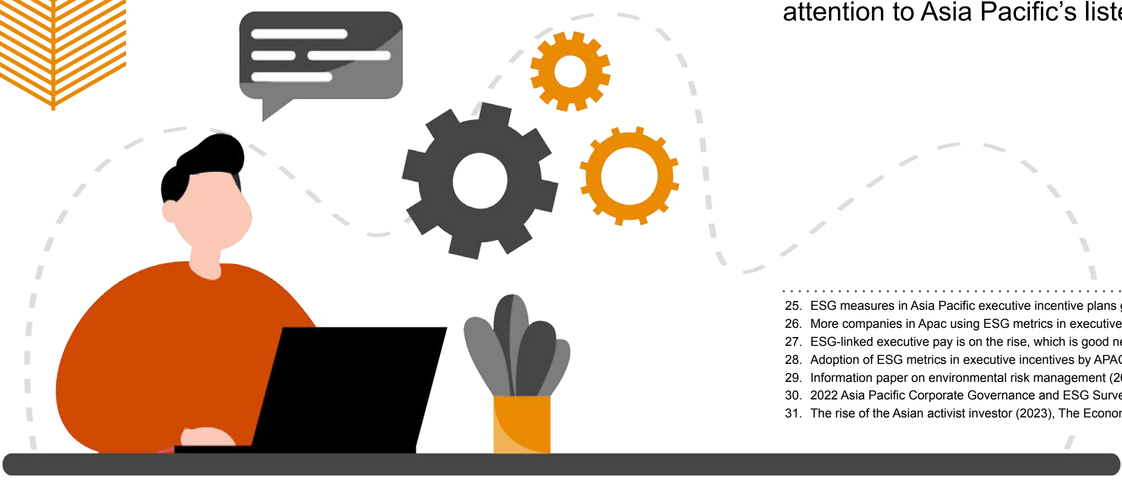
Asia Pacific practices

Today, the disparity in disclosure rates regarding the utilisation of ESG metrics in incentive plans between the Asia Pacific region (62%), the EU (91%), and the US (69%) underscores a significant opportunity[25]. This gap highlights executive compensation as a potent lever to propel decarbonisation efforts forward.

In the Asia Pacific region, only 39% companies have integrated at least one environmental metric, compared to 80% in Europe, 44% in the US, and 50% in Canada. Whilst the Asia Pacific region has demonstrated an 14%-point improvement in 2023 compared to 2022[26], the region still lags behind other markets, which have made more substantial strides in integration, according to a study conducted by Willis Towers Watson (WTW)[25].

The incorporation of ESG metrics into compensation contracts is more prevalent in countries that are more sensitive to ESG issues and have stricter regulations[27] as well as highly sensitive industries such as energy, real estate and industrials, which have a high environmental impact[28]. Compared to the North American and European regions, Asia Pacific is both more fragmented, lacking an overall cohesive approach to ESG and sustainability, and a smaller market.

Investors in Asia Pacific also have varying levels of interest and investments in ESG and sustainability products. Nonetheless, such products exist, enough investors are aware of them and purchase them, policymakers are charting their own courses with regards to frameworks and disclosures, and asset managers are deepening their ESG and sustainability capabilities across the region.



This is starting to be seen with respect to the tying of ESG KPIs to remuneration, with the Monetary Authority of Singapore (MAS) noting in their 2022 Information Paper on Environmental Risk Management[29] that asset managers had started setting and incorporating sustainability-related KPIs into their remuneration framework, with one in particular incorporating the following:

- Number of stakeholder engagements conducted within the year;
- Progress in greening existing real estate portfolios;
- Achievement of green rating targets for newly acquired properties; and
- Operational performance of properties in existing real estate portfolios.

MAS further noted in the same paper that further work was required, specifically around embedding role-specific KPIs pertaining to environmental risk management into the appraisal framework of asset managers and in improving disclosures on the extent to which the remuneration of executives and senior management is affected by said KPIs.

At a portfolio company level, a plurality of Asia Pacific companies do not have ESG-linked incentives for their C-Suite executives, with listed companies doing so at a rate of more than double their privately-held counterparts[30].

A key reason for this may be that companies in Asia Pacific, even listed ones, have a larger concentration of shareholdings among small groups of investors compared to their western peers.

Interestingly, companies in Asia overtook their European peers in 2022 in terms of the number of companies publicly subjected to activist shareholder demands, so having won their victories in Europe and other more ESG-friendly environments, activist investors may now be turning their attention to Asia Pacific's listed companies[31].

25. ESG measures in Asia Pacific executive incentive plans gaining momentum, WTW study finds (2023), Willis Towers Watson
26. More companies in Apac using ESG metrics in executive incentive plans: study (2024), The Business Times
27. ESG-linked executive pay is on the rise, which is good news for the planet (2023), IESE Business School
28. Adoption of ESG metrics in executive incentives by APAC companies increases, WTW study finds (2024), Willis Towers Watson
29. Information paper on environmental risk management (2022), Monetary Authority of Singapore
30. 2022 Asia Pacific Corporate Governance and ESG Survey Results (2023), Aon
31. The rise of the Asian activist investor (2023), The Economist

Asia Pacific practices

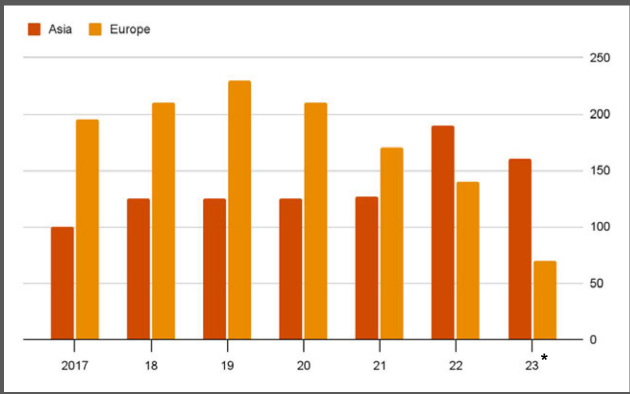
South Korea for instance reportedly had the third-highest number of activist campaigns in 1H23, up from 5th in 2022, and 7th in 2021. This activist-upswing is thought to have been driven by two factors, the spate of corporate scandals that engulfed corporate South Korea in 2015, which ultimately led to a stewardship code implemented for asset managers, and the boom in retail investors which began during the Covid-19 pandemic, which saw a reported 21 million increase in active stock trading accounts over two years to 2021.

Within the companies which comprise investment portfolios, those in Asia tend to be further behind in terms of ESG adoption compared to their European and North American peers, with 38% rated by MSCI as 'ESG Laggards' compared to 17% for North America and 6% for Western Europe[32].

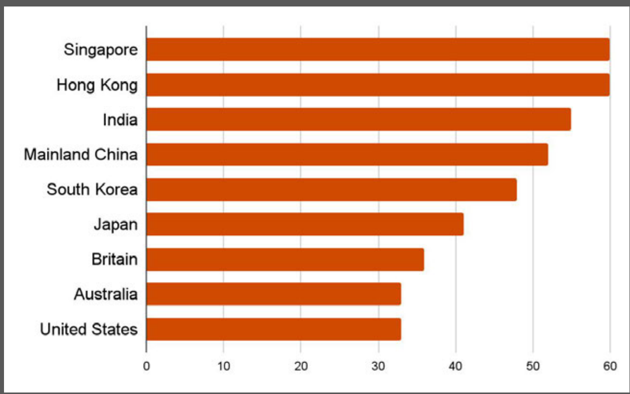
A more promising finding notes that the higher Asia Pacific companies rated on MSCI's ESG scale, the better their performance, with ESG leaders having double the compound annual return as ESG laggards, though this did not extend across all industries.

Investors and protesters

Number of companies publicly subjected to activist demands



Average share of ownership of listed companies by largest three investors, end-2020, %



Sources: OECD; Diligent Market Intelligence

*First half

32. ESG and Global Investor Returns Study (2023), Kroll

Challenges in the integration of ESG considerations in remuneration policies

Challenges and obstacles to the implementation of ESG KPIs into remuneration policies exist at the strategic and operational levels.

Strategic challenges

Strategically, the same forces which brought ESG and sustainability to the forefront of many can swing the other way, likely leading to anything associated or linked to ESG being tarnished by association. While there may be some ways to go before this potential path comes close to actualisation, there are already signs that the fervour with which some asset managers embraced ESG and supported such resolutions in their portfolio companies is waning.

Vanguard for instance has significantly reduced its support for ESG resolutions in 2023 compared to 2022, dropping support to 2% from 12%[33]. The US asset manager noted that changes in company disclosures made the support of many resolutions irrelevant. BlackRock had also dramatically reduced its support of ESG resolutions, supporting only 7% of shareholders ESG proposals over the 12-month period ended 30 June 2023[34]. This was a decrease from 22% over the previous period, and down from 47% the year prior. BlackRock stated that progress from corporations and poorly crafted resolutions were the reasons for the apparent decline in support. This also gathered scepticisms where the $9.4tn asset manager was criticised of being too "woke"[35]. These two prominent public fund managers serve as a microcosm of the wider trend, with average support for voted resolutions pertaining to ESG issues among the Russell 3,000 group down to 25% as of mid-May 2023, down from 38% the year prior, and 43% from the period before that.

The broad decline in support for such proposals may mean that the easy victories have been won, and the ESG resolutions being put forward nowadays are more onerous and burdensome on investors than those of yesteryear. As noted by Vanguard, company disclosures and those required by regulators may make some of the resolutions put forward redundant too. At the other end of the spectrum, the deepening battle lines being drawn in areas like ESG may make public managers baulk at supporting resolutions, with BlackRocks's Larry Fink recently stating that he no longer used the term ESG due to its connotations.

Operational challenges

Operationally, the integration of ESG KPIs into remuneration is impacted by many of the challenges asset managers face in the wider ESG environment, these include:

Lack of standard metrics: Investment managers face issues in identifying and implementing consistent ESG KPIs within investment portfolios, leading to a wide range of interpretations regarding the actual performance and impact of products marketed as ESG or sustainable. This lack of standardisation would impact any attempt to link ESG KPIs to remuneration, making it challenging to establish a clear, consistent, and transparent framework.

Reliable and accessible data: Data to assess the ESG performance of investments and portfolio companies varies considerably in its availability, consistency, and quality. With varying degrees of these factors, and others, being observed at both an inter and intra industry level. Tying compensation to KPIs and metrics which cannot reliably be measured, or which have substantial inconsistencies regarding their measurements, may be a challenging sell to employees of all levels, and not something they may be too fond of.

33. Vanguard joins BlackRock, cuts support for shareholder items on climate, social issues (2023), Reuters
34. BlackRock continues lowering support for environmental and social proposals (2023), Reuters
35. BlackRock's support for climate and social resolutions falls sharply (2023), Financial Times

Challenges in the integration of ESG considerations in remuneration policies

Operational challenges (continued)

Deciding what to measure: Within the ESG framework, is a wide range of objectives and criteria, and the selection of what to focus on when measuring someone's ESG metrics and factoring this into their remuneration may prove challenging to effectively implement. Deciding to what extent impact or intent, short-term or long-term, the E; S; or G, and a range of other factors should be considered, and who the decision benefits the most, may make for a long and convoluted process. Should entities decide to have multiple frameworks and metrics for a range of executives depending on their roles and responsibilities, then additional cost and complexity will be added to the mix.

Risk of miscalibration of targets[36]: At times, companies might set out easily attainable targets to enhance their appearance in sustainability reports. However, this approach undermines the fundamental purpose of ESG compensation, which is to foster substantive and impactful change. Targets considered should be ambitious, rigorous and realistic instead of those that can be achieved easily by companies as it will lose its purpose of driving meaningful change.

Deciding how to measure: In addition to the challenge of what to measure, how to measure the metrics will need to be considered. As with the 'What to measure' challenge, how the KPIs selected for a framework are measured may prove challenging.

Agency theory: People generally respond to incentives, which, given the situation, can lead to the creation of perverse incentives, highlighted by the examples of rats in Hanoi, cobras in Delhi, poppy farmers in Afghanistan, and gun buy-backs, along with a myriad of other examples. Depending on what metrics and KPIs are selected, may mean those whose remuneration is tied to them change their behaviours to reflect the change in incentive. For an asset management company, this may mean a mis-alignment between maximising investment returns in order to reach ESG-related targets.

Goodhart's Law would be an excellent adage to mention, noting that "when a measure becomes a target, it ceases being a good measure". Should remuneration be tied to meeting or exceeding ESG KPIs and metrics, great care will be needed at an individual and organisational level to ensure and safeguard against said measures and metrics becoming targets for those subject to them.

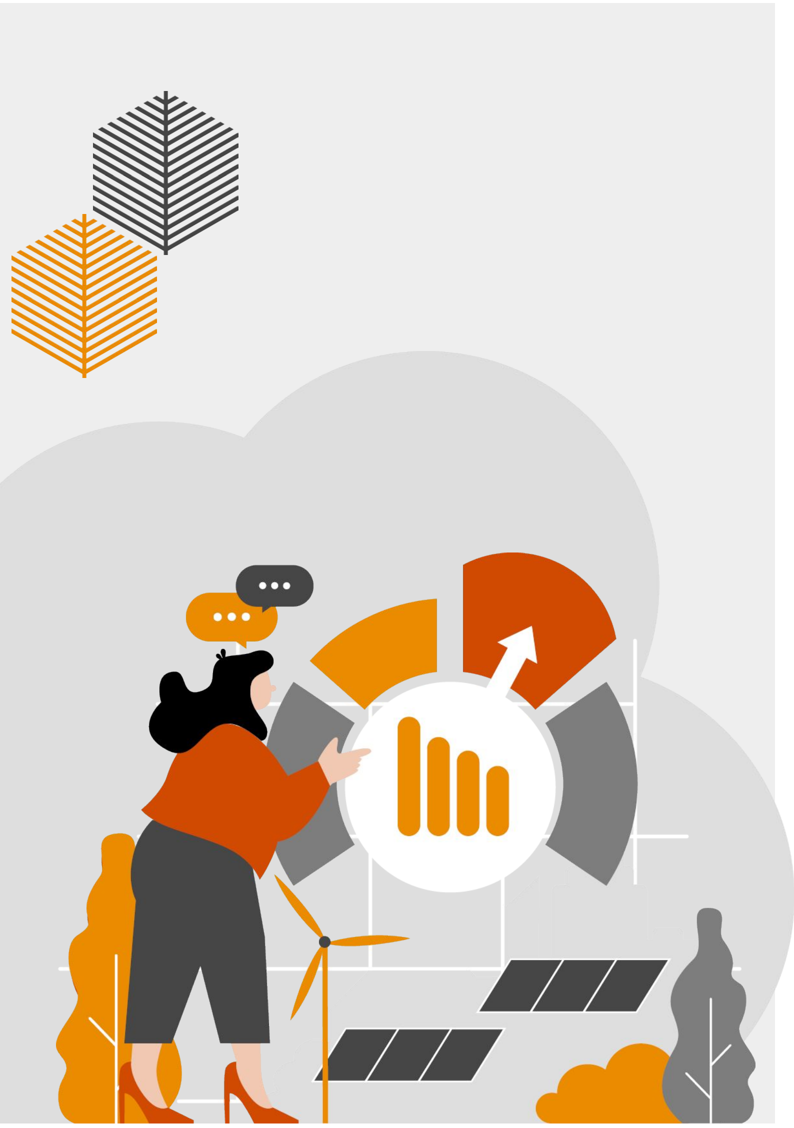
36. Linking executive pay to ESG goals (n.d), PwC Malta

Integration of ESG metrics into executive compensation

Corporate strategy alignment

Effective ESG linked compensation should align with corporate strategy to instigate meaningful change[37]. ESG metrics incorporated should directly correlate with the objectives that the corporation is already pursuing, reinforcing executive and shareholder focus on those specific goals.

From the most recent Annual Corporate Directors Survey, only 54% of directors say that ESG is linked to their company's strategy[38]. Yet, many investors are focused on the connection between sustainability goals and executive compensation. A growing number of shareholder proposals are also demanding for the linkage between the two[39]. The majority of senior leaders (78%) and investors (86%) that were surveyed recognise that a focus on ESG in company strategy supports enhanced shareholder value[40].



Four key design dimensions of ESG remuneration

When creating a framework for measuring ESG performance against KPIs, it is recommended to include four design dimensions into the finalised matrix[41], these are:

1. **Internal and external targets**

   Internal targets comprise input measures that can be used to measure and compare against the firm's prior results. They are measured by activities that lead toward a stakeholder outcome, not by the outcome itself. Conversely, external targets make use of output measures that are used to assess the degree of impact derived in relation to the stakeholder impact (e.g. the total carbon footprint of the firm). Whilst either measure is valid, each one needs to be readjusted in accordance with the organisation's strategic priorities in order to collect, analyse and communicate the data needed to assess whether targets have been met.

2. **Individual KPIs and scorecards**

   It is important to keep track of and measure progress towards ESG goals. Some companies prefer focusing on trying to achieve several critical ESG issues with a few essential KPIs, whereas others may take more of a general and holistic approach including metrics such as diversity and inclusion, employee welfare and supply chain issues to their ESG agenda. In this regard, a carefully constructed and transparently disclosed scorecard will allow firms to track such benchmarks and ensure a fair balance is achieved between metrics so as not to overcomplicate the process and end up with some measures being disregarded instead. A pragmatic approach is essential to maintain the sustainability of such KPI's over the long-term.

37. Bringing ESG into Executive Pay (2020), PwC United Kingdom
38. Today's boardroom: confronting the change imperative (2023), PwC United States
39. Sustainability and ESG oversight: the corporate director's guide (2024), PwC United States
40. Paying for good for all (2022), PwC United Kingdom
41. Linking executive pay to ESG goals (n.d), PwC Malta

Integration of ESG metrics into executive compensation

Four key design dimensions of ESG remuneration (continued)

3. **Long-term incentive plan (LTIP) and annual bonus**

   Environmental goals tend to sit more comfortably within a LTIP set out by organisations, given their relative long-term orientation. However, other ESG factors such as gender-equality as well as health and safety, which have gathered significant traction, can be calibrated over a single-year. The analysis of the FTSE 100 companies found that 55% of ESG measures related to pay were tied to bonuses and 50% were linked to the LTIP. In terms of its weightings, companies normally devote about 10% of their total incentive (bonus and LTIP measures) to ESG[42] .

4. **Underpins and scale targets**

   One can make use of performance scales in order to establish ESG targets, for example when measuring objective targets such as a reduction in CO2 emissions. This tends to apply for most transformational objectives, but may not always be the case. Certain metrics such as those found within health and safety may be difficult to quantify. Due to the increased subjectivity present, there is a greater likelihood that such measures will be taken advantage of by senior management.

   Financial institutions in particular who are looking for guidance around any ESG and sustainability KPIs they are looking to implement with regards to executive compensation can also draw on the resources and materials available via initiatives such as the PRI, something which has circa 5,000 signatories across asset owners, asset managers, insurers, and service providers.

   Specifically, the PRI in a submission to the U.S. Securities and Exchange Commission (US SEC), noted that investors required ESG metrics which were "comprehensive, reliable, and consistent" and that companies should not be rewarded for simply adhering to regulations and legislation already required of them.

   Not every ESG or sustainability metric will be relevant to every company or organisation, and it is crucial for appropriate factors to be chosen in order to maximise their impact. Ideally, the factors chosen should align with the long-term sustainability goals, objectives, and strategies of the organisation in question.

Nature of metrics

Definitions of materiality: Metrics selected should be material to the business. This includes those that support long term value creation that are critical to a company's overarching strategy. These measures must be balanced with investor wishes for measures that address systemic risks or the preferences of their beneficiaries or society.

Measurable and comparable targets: Incentive targets should be robustly measurable, quantifiable and potentially also auditable[43]. This allows comparison amongst industry peers and for meaningful tracking over time. If possible, metrics should be defined using widely accepted methodologies such as those that are validated by third parties for greater comparability. Furthermore, it will be good for companies to adopt a well-rounded method to performance and measurement beyond just capturing of carbon emissions by the alignment with a company's transition strategy and the wider economy transition. These metrics can involve investments or innovation goals to support climate solutions or engagement measures to encourage counterparties with their transition.

Reporting progress: When reporting targets, it is essential to provide clarity, transparency, and consistency.

42. Paying for good for all (2022), PwC United Kingdom
43. Linking Executive Compensation to ESG Performance (2022), Harvard Law School Forum on Corporate Governance

Conclusion

With ESG AUM forecast to reach USD 33.9 trillion by 2026[44] and poised to represent 21.5% of total global AUM within five years from 2022, asset managers operating in both the private and public investment sectors and all regions of the world partaking, it seems inconceivable that some aspects of an asset manager's remuneration will not be linked to KPIs pertaining to ESG and sustainability.

As things currently stand, several global asset managers in both the public and private markets have already implemented this practice, though industry consensus on what should be measured and how it should be measured, remains to be determined.

As ESG investing deals with allegations of 'greenwashing' and steps to improve transparency, accountability, and knowledge sharing across the space grow, linking financial incentives to actual performance in the ESG and sustainability space, especially when tied to specific and measurable KPIs, provides accountability and responsibility in a transparent and measurable way. This is something which regulators, policymakers, and investors no doubt will appreciate, in addition to the portfolio managers and investment management executives whose compensation is tied to said performance.

Landmines and pitfalls abound though, for, as witnessed when investment managers were enthusiastically describing any product with a modicum of green or sustainability about it as an ESG fund, industry stakeholders will likely demand substance to back-up the measures. This will put the spotlight onto the specific KPIs and means of measurement.

As any budding consultant should know, the SMART (specific, measurable, attainable, realistic, and timely) framework provides a sound foundation on which to build KPIs and other performance measures. Thus, providing an excellent starting point for remuneration committees, sustainability committees, and other stakeholders, from which to begin their journey to tie executive remuneration to meeting ESG and sustainability goals and objectives.

A much smaller group may be familiar with the words of accounting historian, yes; really, and author of 'Relevance Lost' and 'Relevance Regained', among other works, H. Thomas Johnson.

His words of "Perhaps what you measure is what you get. More likely, what you measure is all you'll get. What you don't (or can't) measure is lost.", should be emblazoned and in full view of anyone creating such KPIs, to serve both as a reminder of what should be measured, as well as cautioning what may be lost by such measuring.

Linking financial incentives to actual performance in the ESG and sustainability space, specifically, when tied to specific and measurable KPIs, provides accountability and responsibility in a transparent and measurable way. These attributes should not be lost due to measures becoming targets or lost in executives' pursuit of them.

44. ESG-focused institutional investment seen soaring 84% to US$33.9 trillion in 2026, making up 21.5% of assets under management: PwC report (2022), PwC United States

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