Bringing ESG into Executive Pay

Introduction

Climate change, plastic pollution, water shortages, Black Lives Matter and poor working conditions. These are just some of the global issues that define our times. These social and environmental issues are now also becoming business critical issues for UK plc - not only for reputational reasons, but because the future strength and viability of a company will often depend on the adaptations they make. As a result, companies are increasingly considering the use of Environmental, Social and Governance (ESG) goals within executive pay, linking incentive outcomes with delivery of meaningful change in these areas.

This document sets out current market practice in this area - together with some thoughts and guidance on how to begin incorporating ESG into executive pay.

In the past it was sometimes asked whether ESG belonged in pay. After all, surely running a business in a sustainable and socially responsible way should just be part of the job, not something worthy of extra reward. But in recent years, ESG has taken on a new level of importance. There is now a general acceptance that environmental and social issues - and climate change above all others - present an immense global challenge for governments, institutions and indeed every one of us. Business is no exception, and it is clear that ESG issues are critical to the future of every company and every investor.

The long term viability of many businesses depends on adapting to climate change and limiting its future trajectory. Without action, assets may be stranded and businesses left behind by those better placed to operate in a new sustainable energy system. Failure to minimise plastic waste and water consumption will leave a company exposed to changing customer demand for 'green' products. And as we drew out in our report 'Are you Missing Millions?', companies that fail to capitalise on the rich diversity of society fail to attract the best talent and miss out on innovation and market share.

These challenges, alongside increasing regulation and powerful social movements are causing businesses to examine the wider impact they have and who their core stakeholders are. For many, linking this to executive pay is a logical next step - to ensure strategic alignment, but also to signal to investors and stakeholders that the company is acting.

Another good reason to have ESG in pay is the inherent tension between delivery of profitability today and the investments and transformations needed to mitigate the climate crisis and other environmental challenges. Balancing Earnings per Share (EPS) and other profit measures with a specific ESG measure may therefore be a necessary step to ensure executives are not disincentivised to deliver change.

A strong impetus in the financial sector is the pressure to manage climate risk in the financial system. Since Mark Carney's 'Tragedy of the Horizon' speech in 2015, climate risk in financial services has risen up the agenda. From next year, disclosure aligned to the recommendations of the Taskforce on Climate related Financial Disclosures (TCFD) will be required on a comply or explain basis for UK premium listed companies and as an expectation for PRA regulated firms. A roadmap to mandatory disclosure across most listed companies and financial services firms by 2023 was recently released by the Treasury. With climate risk so high on the regulatory agenda, executive pay could be one tool to demonstrate and incentivise action. Indeed, Mark Carney recently promoted the idea that banks should link sustainability targets to Executive Remuneration.

It's worth noting that some investors - such as Legal and General (LGIM) - take the view that ESG performance targets should act as a modifier to incentive outcomes, rather than providing additional reward. But LGIM do also note that companies that are exposed to high levels of environmental, social or reputational risk (or have specific ESG strategic objectives that extend beyond the company's purpose) may set targets that focus on these.

What is happening in the market?

While companies have included ESG measures within executive incentives for some time, this has generally been as a very modest part of the annual bonus, often sitting within a strategic or personal scorecard.

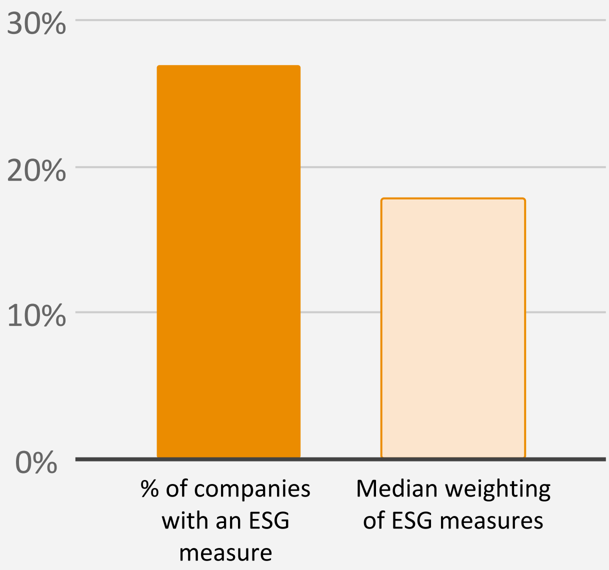
However we are now seeing a rapid shift towards the use of environmental and social targets in a more material way across both the bonus and the long term incentive. Boards and their remuneration committees are increasingly interested in how they can include these targets. The challenge is getting a framework for target setting and measurement that is right for the company and investors.

35% of FTSE 100 companies have an ESG performance measure as part of executive incentives*:
- 27% of the FTSE 100 have an ESG measure in the annual bonus; and
- 13% have an ESG measure in the long term incentive plan (LTIP). There is some duplication - 5 companies have both a bonus and LTIP ESG measure.

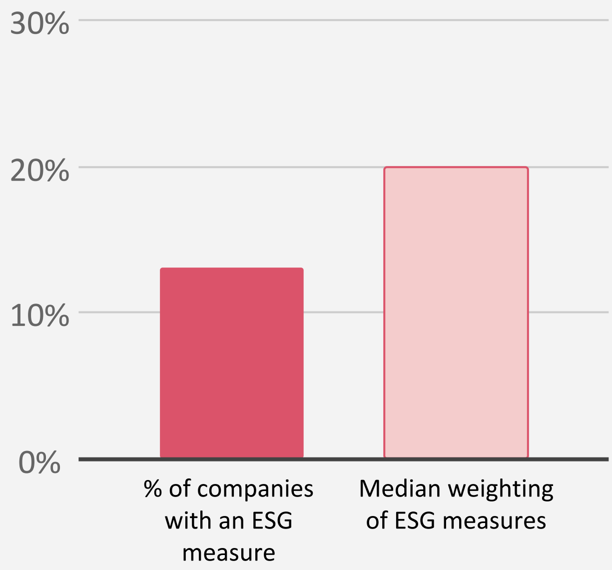
12% of companies apply an ESG underpin to the bonus or LTIP. Again there is some duplication here, and 7 companies have a stand-alone ESG measure *and* an ESG underpin.

In total this means that **40% of the FTSE 100 have an ESG performance measure or underpin (or both)**.

Bonus



LTIP



Graph shows data for bonus paid in respect of the last financial year (i.e. the 2019 annual bonus for companies with a 31 December 2019 year-end).

Graph shows data for LTIP implementation in respect of the next financial year (i.e. the 2020 LTIP grant for companies with a 31 December 2019 year-end).

**This analysis is based on stand-alone measures relating to environmental, social and governance issues. It excludes measures relating to employee engagement or customer satisfaction. Note that ESG components forming part of wider personal scorecards, but without distinct weightings for the ESG element are excluded. Bonus data relates to the bonus paid in respect of the last financial year, and LTIP for implementation in respect of the next financial year.*

What is happening in the market?

Looking at the market data in more depth tells us that:

The weighting of ESG measures is typically slightly higher in the LTIP than in the annual bonus (at the median, ESG measures represent 20% of the overall incentive for LTIP, and 18% for bonus).

Where standalone ESG measures are used in the bonus, most are industry focussed, such as health and safety measures in the basic materials sector, or risk and governance measures in financial services.

While bonus measures are spread across the full breadth of sectors, LTIP measures are currently predominantly found in the extractive industries and financial services (although examples exist in other sectors - in particular consumer goods).

In the bonus, 85% of the companies with an ESG measure have a metric related to governance (e.g. health and safety or risk). Social (48%) is the second most prevalent bonus ESG measure type with environmental (37%) being the least common.

In contrast, there is a much greater focus on environmental targets in the LTIP: 85% of companies with an ESG element in the LTIP include some form of environmental measure. 54% include social measures and 23% include governance measures.

So what does this tell us? The inclusion of an ESG target in the LTIP is most frequent in sectors where ESG is business critical – such as the extractive industries (where environmental impact is greatest and stranded asset risk is high), and financial services (where risk and governance are subject to regulatory focus and public scrutiny).

Interestingly, financial services companies seem to prioritise diversity in pay targets, often including them in the LTIP – perhaps in recognition of the benefits a diverse population can bring to the sector.

The higher frequency of *environmental* metrics (compared to social or governance elements) in LTIPs is also telling. Environmental and sustainability targets tend to be long term by nature, and often require the kind of longer term strategic focus that the LTIP incentivises.

Thoughts on developing an ESG measure

There is no shortage of options where ESG measures are concerned. Choosing the right objectives requires much careful thought – and target setting and measurement may be challenging, particularly given the long term and transformational nature of some environmental goals. Each company will have their own unique interactions with the environment and wider stakeholders – and any ESG measure should reflect this.

We set out below 5 key principles to bear in mind – and some questions to ask through the process.

1. Keep it strategic

First and foremost it is important to build remuneration metrics out of the ESG goals you have already prioritised strategically. A good environmental or social responsibility pay metric will be linked to a goal you are already pursuing, reinforcing the focus on that objective to executives and to shareholders. The IA recognise this in their latest principles - encouraging companies to choose ESG measures that are clearly linked to the implementation of strategy.

In thinking about what ESG metrics to use there are a number of initial scoping questions to ask: Who are the key wider stakeholders for our business? What is our biggest environmental or social impact? Where can we make the greatest positive contribution? Where have we got the most ground to make up?

2. Think input or output

Generally speaking, ESG measures can fall into one of two types; input and output. Input measures focus on actions - environmental initiatives, developing low carbon technologies, or implementing a new diversity policy. They are easy to evidence and measure, and are well suited to short term incentives.

Output measures on the other hand represent a measurable ESG endpoint or outcome. For example, emissions reduction targets, reduced water consumption, or a higher representation of ethnic minorities in leadership positions. For environmental goals these are often necessarily longer term - reducing CO_2 emissions or reducing the climate exposure in assets under management are multi-year endeavours.

Schroders have indicated that they favour output measures across incentives - including for ESG.

3. Measuring and reassuring

Incentive targets should, as a rule, be robustly measurable. As with financial targets, investors will be more comfortable with figures that link back to reported and audited numbers based on a recognised standard. In their latest guidance Blackrock state that ESG measures should be 'quantifiable, transparent and auditable' - with LGIM saying that where ESG targets are appropriate, they should be measurable.

Sustainability reporting standards such as those from the Global Reporting Initiative (GRI) or the new World Economic Forum/International Business Council ESG framework provide consistent metrics that can be used for targets.

Reassurance, validation and audit can be obtained for the majority of ESG goals - ranging from comprehensive assurance of sustainability performance to more bespoke validation of, for example, supply chain compliance with the living wage. When introducing an ESG measure, how you reassure investors (and wider stakeholders) of rigour is an important consideration.

4. Beware the ESG rabbit hole

Even within recognised ESG reporting standards, choices abound. As an example consider decarbonisation. Do you set Scope 1 targets (direct emissions you create) - or add Scope 2 (emissions from the energy you purchase)? These are both required disclosures for quoted companies and straightforwardly measurable - but some may go a step further and select Scope 3, incorporating all emissions in the value chain, from business travel and commuting to the use of sold products.

Scope 3 is comprehensive, and for many companies provides a greater understanding of the emissions within their influence. But it is more complex to measure, and by its nature much harder for executives to directly impact.

Some companies will build their own custom emissions metrics dependent on sector - a net total emissions or perhaps CO_2 per passenger km.

As with any performance measure, the answer in most cases is to start with the internal KPI - something recognised throughout the business. Where no common internal ESG KPIs are in use, then a focus on standard reporting options - and keeping it simple - would be a sensible approach.

5. It's not just about executives

Tying executive incentives to ESG metrics is an important step, and sends a powerful signal, both internally and externally, about an organisation's priorities. It is however possible to go further. Cascading ESG metrics through the business, particularly if existing goals 'at the coalface' are at odds with sustainability objectives, will help ensure real change follows. Companies will need to ensure that management and the wider workforce are aligned to their ESG priorities through reward, but also at a deeper level, ensuring culture and behaviours inherently drive sustainability, decarbonisation and corporate social responsibility.

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