Guerdon Associates

Remuneration, ESG

a GECN GROUP company

2022 Global Trends in ESG Incentives:

Executive ESG pay not relenting

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Guerdon Associates Pty Ltd is an independent consulting firm that provides remuneration and ESG services that contribute to improved and sustainable shareholder value. As a member of the GECN Group brings together behavioural, financial and legal disciplines, comprehensive data and research, a measurement framework, and a global group to achieve this regionally, nationally and globally.

The Global Governance and Executive Compensation (GECN) Group is comprised of leading independent firms around the world specialising in executive compensation, performance management, and governance. The GECN Group serves hundreds of clients in more than 35 countries across five continents, working with boards of directors, C-suite executives, investors, heads of public authorities, and other decision-makers to enhance stakeholder value.

About This Report

Longer-term trends are becoming evident as companies continue their environmental, social, and governance (ESG) journeys. This year's sixth annual research report by the Global Governance and Executive Compensation Group (GECN Group), is titled ***2022 Global Trends in ESG Incentives: Executive ESG pay not relenting***. It explores how companies around the world seek to incorporate ESG measures into their executive compensation plans. This year's research picks up from last year and details the current and last two years of global and regional trends in the specific use of ESG incentives. The regional differences among companies' use of ESG incentives is striking. Given that capital is global and liquid, this presents issues for boards seeking ways to best respond to investor needs representing multiple markets. We trust this report provides insightful data for compensation plan design.

Client Service Collaboration	Knowledge Sharing	Employee Exchanges	Data Exchange (pay, practices)	Client Publications

Study Methodology

This year's research is again global in scope, covering Australia, Canada, continental Europe, Singapore, South Africa, the U.K., and the U.S. We researched and analysed data on ESG incentives from the most recent public disclosures of all companies listed in the following indices:

- Australia - ASX 100
- Canada - TSX 60
- Continental Europe
  - France - CAC 40
  - Germany - DAX 40
  - Switzerland - SMI 20
- Singapore - STI 30
- South Africa - JSE Top 40
- United Kingdom - FTSE 100
- United States - S&P 100

To discern the bigger picture and the trends and details revealed therein, all ESG measures were grouped into the following categories:

Categorisation of ESG Incentive Measures

SOCIAL

- Fatalities
- Injuries
- Illnesses
- Exposure to Harmful Substances
- Workplace Policies
- Gender Balance
- Diversity & Inclusion
- Employee Engagement
- Training and Development
- Behaviors, Ethics, Values, and/or Culture
- Employee Voluntary Turnover
- Other

ENVIRONMENTAL

- Scope 1, 2, and 3 GHG Emissions
- GHG Emissions (scope not specified)
- Non-Renewable Energy
- Renewable Energy
- Environmental Incidents
- Air Quality
- Land Management
- Water & Wastewater Management
- Waste & Hazardous Materials Management
- Sustainability
- Other

CUSTOMER

- Customer Satisfaction
- Customer Net Promoter Score
- Customer Complaints and Resolutions
- Product Quality and Safety
- Other

COMMUNITY

- Community Incidents
- Community Complaints
- Community Investments
- Other

GOVERNANCE

- Governance at the Board of Directors' Level
- Governance at the Executive Level
- Risk Management
- Compliance
- Behaviours, Ethics, Values, and Culture
- Other

Executive Summary

While the global pandemic focused attention on the health and wellbeing of the workforce, the ongoing conflict in Ukraine causing both humanitarian and economic crises raised serious geopolitical questions. As this report was going to press, the ramifications of the war on business were evident in the rate of inflation, increased energy prices, and the decline of global stock markets. Recession looms in Europe, the U.S., and Britain. The stakeholder capitalism movement that had given rise to a steady embrace of environmental, social, and governance (ESG) initiatives does not appear to be slowing down despite the economic headwinds and decline of shareholder returns.

Some detractors question the moral authority of private enterprises to weigh in on the "values" issues that ESG initiatives encompass, while others, including activists, consider investments in companies that only consider ESG matters in terms of "value."

Within this context, the GECN Group undertook its third consecutive annual survey of ESG trends in executive incentives. The larger trends, highlighted in this report, show an ongoing commitment to ESG incentives despite uncertainty and pushback.

We provide a description of each trend's "context," followed by an assessment of the "current state," and a forward look at what each trend portends in "predictions."

"It may well be in the long-run interest of a corporation that is a major employer in a small community to devote resources to providing amenities to that community or to improving its government. That may make it easier to attract desirable employees, it may reduce the wage bill or lessen losses from pilferage and sabotage or have other worthwhile effects."

– Milton Friedman
American economist, writing in *The New York Times*, Sept. 13, 1970

CONTEXT

- Investor and issuer priorities are evolving with longer-term perspectives and with greater consideration of stakeholders.

CURRENT STATE

- Issuers continue to focus on and refine their ESG measures in executive incentives for either "value," "values," or a bet each way.

PREDICTIONS

- As companies continue to better define and articulate alignment between stakeholder and shareholder value, the focus on "value" will overcome a focus on "values."

Trends in ESG Incentives

The GECN Group's reporting on this global research over consecutive years reveals a pattern in the use of ESG measures. This pattern allows us to relate trends and predictions within four primary categories that represent the common stages of a corporation's ESG journey. These four categories are **Adopt**, **Select**, **Incorporate**, and **Verify**.

Stages of the ESG Incentives Journey

ADOPT	• Companies begin considering ESG matters into their long-term business strategies. As a result, companies should start to determine whether ESG measures should be adopted in their incentive plans to reinforce those strategies.
SELECT	• Companies have big ambitions for their contributions to a more sustainable future. The decision to use ESG measures often hinges on whether companies can identify and set valid goals on ESG measures that reinforce the strategy.
INCORPORATE	• ESG measures are increasingly being used in short- and long-term incentives. • Use of ESG measures in incentives is evolving, reflecting measurement abilities. • ESG measures are most often incorporated into incentives using scorecards or weighted measures. Either way, quantification is trending, overtaking milestone setting.
VERIFY	• Many countries and their regulatory agencies are requiring more robust reporting from corporations on their progress around ESG initiatives. Although companies must comply with minimum standards, many also choose to go above minimum requirements to provide a more complete picture and "showcase" their efforts. There is now a clear expectation that all representations and claims around ESG measures and goals be rigorous, supportable, and verifiable.

To augment our research, GECN Group firms reached out to directors, investors, and corporate governance experts to gauge their reaction to this year's findings and have incorporated their thoughts throughout this report. One example is Yale University's influential Jeffrey Sonnenfeld, who provided a historical perspective: "I have thought about the role of businesses in society for almost five decades. In 1977, George Weyerhaeuser, a lumber baron, told me how he viewed his firm's position: 'We have a license to operate from society, when we violate its terms, it can be revoked.' In 1985 Johnson & Johnson's CEO, James Burke, told me that 'our most powerful tool is institutional trust, which is real, palpable, and bankable. Every act that builds that trust enhances the value long-term of the business.' Stakeholder capitalism' is not new. But the backlash against it is."

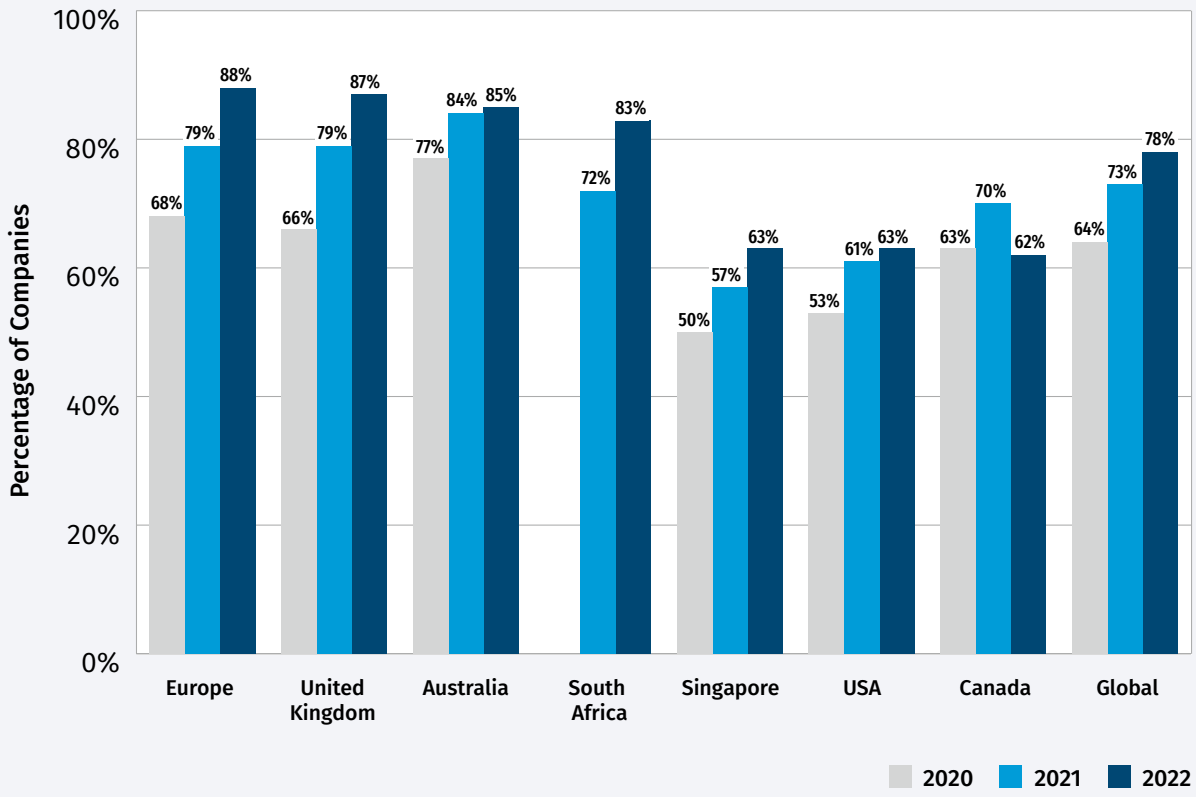
ADOPT: The adoption of ESG measures continues to increase, but the rate of growth is slowing

Context

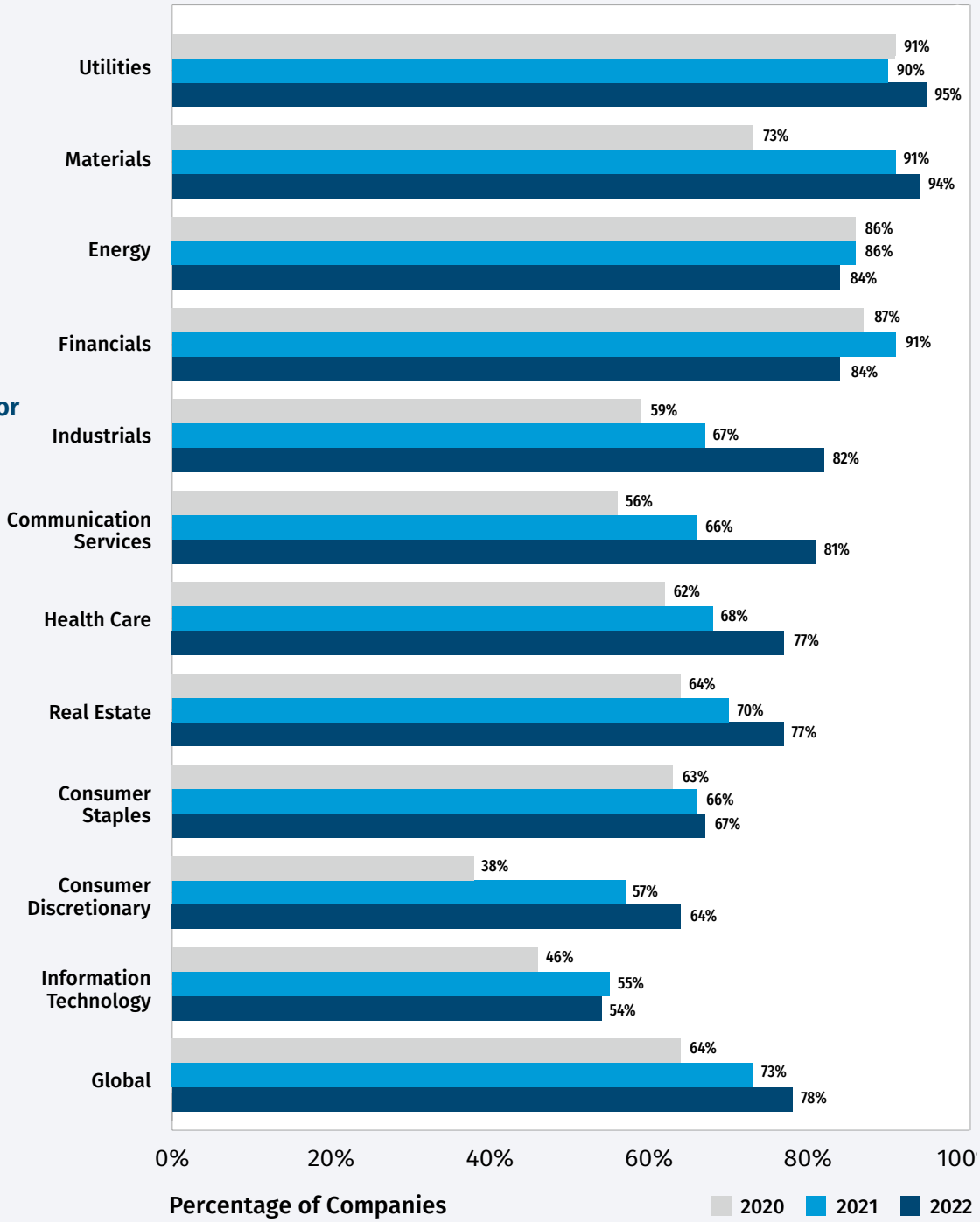
Institutional investor policies have evolved, shaped by the dominance of index investing and increased pressure to "invest with a conscience." As investors take longer-term perspectives on their holdings, they are engaging directly with issuers around their ESG and sustainability strategies to gauge the strength, longevity, and riskiness of corporate cash flows and profitability. However, there continues to be many instances of shareholder activism on ESG matters supported by hedge funds, long- and short-term investors, and specialist ESG fund managers, among others, seeking to make fast returns. ESG measures in remuneration have been used as part of an effective defence strategy as many investors consider ESG incentives to be a sign that companies take sustainability seriously. Moreover, companies want to communicate their ESG intentions both internally and externally. These forces have contributed to a rapid increase in the adoption of ESG measures in executive incentives.

The importance of ESG to healthy corporate cash flows over the long term is borne in the notion that shareholders and other stakeholders win together. They are interdependent. Yet some directors, executives, activist investors, and regulators believe that the attention placed on the interests of non-shareholder stakeholders will detract from the interests of shareholders, and therefore, companies should not divide their attention between the two interests.

Prevalence of ESG Incentive Measures by Region



Prevalence of ESG Incentive Measures by Sector



Current State

- More than three-fourths of large companies now incorporate ESG measures into their incentive plans
- This prevalence is up by 5 percentage points compared to 2021 and 14 percentage points compared to 2020
- Differences between regions are reflective of each region's industrial base, cultural norms, and local regulations. However, all regions but Canada are moving in the same direction—up
- Europe, the U.K., Australia, and South Africa lead the market with over 80% of large companies incorporating ESG measures into their incentive plans
- The other regions—the U.S. and Singapore—are increasing their use of ESG measures in compensation, but not to the same extent
- By sector, Utilities and Materials lead the market with more than 90% of companies using ESG measures in compensation, which has not changed materially from last year
- Companies in the Information Technology, Consumer Discretionary, and Consumer Staples sectors have the lowest (albeit still significant) use of ESG incentives measures with less than 70% prevalence, with Consumer Discretionary companies demonstrating the steepest uptake in ESG measures among all sectors over the past three years

ADOPT

Predictions

- Companies in regions and industry sectors with lower use today will continue to experience growth in the use of such measures

Arguments For vs. Against Including ESG Measures in Incentives

ARGUMENTS FOR

- ✓ Shows that the company is "walking the talk"
- ✓ Aligns incentives with the company's ESG strategy and commitments
- ✓ Focuses participants on areas requiring improvement
- ✓ Impresses investors who view ESG metrics favourably
- ✓ Meets investors' expectations that companies consider ESG and stakeholders in compensation decisions
- ✓ Responds to valid risk factors previously unrecognised
- ✓ Adds value through customer and/or investor demand, and community and regulator support
- ✓ Addresses value sustainability beyond typical incentive period

ARGUMENTS AGAINST

- ✗ May contribute to incentive plan complexity
- ✗ May not be the most effective way to mobilize the organisation around ESG initiatives
- ✗ May be a challenge internally to agree on which ESG measures to use
- ✗ May not be easily quantifiable, and it can be costly to ensure what is promised is actually delivered
- ✗ May be perceived as augmenting incentive payouts by some investors
- ✗ May not add value and add unnecessary cost
- ✗ May not be able to measure within a reasonable timeframe

"It is challenging, yet important to distinguish realistic and pragmatic targets from (very) long-term aspirations. The former can be integrated into short-term or long-term incentives; the latter should not make their way into incentives."

– **Jean-Christophe Deslarzes**
Chair of the Board of Adecco Group, Zurich, and of Constellium, Paris

ESG Compensation Policies Among Select Global Investors

NO POLICY

- **AustralianSuper**
- **Charles Schwab Asset Management**
- **Fidelity**
- **Norges**
- **Nuveen (TIAA)**
- **State Street**

POLICY DOES NOT REQUIRE ESG

Allianz

- Companies identified as top CO_2 emitters are engaged on climate strategies, and may be encouraged to tie executive compensation to metrics relating to climate change, such as GHG emissions

BlackRock

- If ESG measures are used, they should be:
  - Directly relevant to the company's business model
  - Aligned with its long-term strategy
  - As rigorous as other targets

T. Rowe Price

- Companies electing to include ESG metrics in their compensation plans should demonstrate that such metrics are:
  - Material to the company's results
  - Quantifiable

Vanguard

- If ESG measure is used, it should be:
  - A real metric, not simply a signal
  - As rigorous as other targets
  - Aligned with the company's long-term strategy

POLICY EXPECTS/REQUIRES ESG

AllianceBernstein

- Companies should incorporate ESG measures into executive compensation plans, and they should be appropriate and well-implemented, meaning they are:
  - Material
  - Measurable
  - Disclosed with rationale
  - Disclosed with performance against goals

Amundi

- Companies from sectors highly exposed to climate change and its mitigation (e.g., Oil & Gas, Industrials, etc.) should use a climate-related metric in incentives

Hermes EOS Global

- Engagement strategy expects to see executive pay programs aligned to delivering net-zero goals

Legal & General

- Companies exposed to high levels of ESG risks should include relevant and measurable targets focused on mitigating those risks. ESG metrics should be:
  - Meaningful
  - Measurable
  - Aligned with company strategy
  - Subject to third-party verification

Northern Trust

- APAC and EMEA companies are expected to use company-specific performance measures that consider environmental and social risks

UBS Group

- Large companies that are a part of Oil & Gas, Materials, Chemicals, and Automotive sectors are expected to link compensation to climate change targets

Investor expectations on ESG and compensation are being formalised into policies

Large investors have driven companies to adopt sustainability strategies and targets, diversify their boards, and disclose ESG information. A more recent development has been investors' role in driving the integration of ESG measures into incentive plans.

While many investors do not have a formal policy on ESG measures in compensation, some of the largest asset managers have released specific policies of their expectations. BlackRock and Vanguard, for example, are not pushing for companies to use ESG measures in pay, but if companies use such measures, they expect the same level of goal rigour as that used for other financial or non-financial metrics. Meanwhile, AllianceBernstein, Allianz, Amundi, Legal and General, and UBS, among others, have engagement policies that encourage the adoption of ESG incentive measures, and particularly climate measures for companies in certain industries. It should be noted, however, that some of these stakeholders are not asking for a pay connection to all of ESG, or even all of the "E." Some are making the linkage only to a part of the "E," such as climate targets.

SELECT: The increasing use of environmental measures is a global trend across industries with a focus on GHG emission reductions

"Organisations have no choice but to ensure that their commitment towards ESG is more than words. They must translate their commitment into meaningful actions. Variable pay plans provide this opportunity."

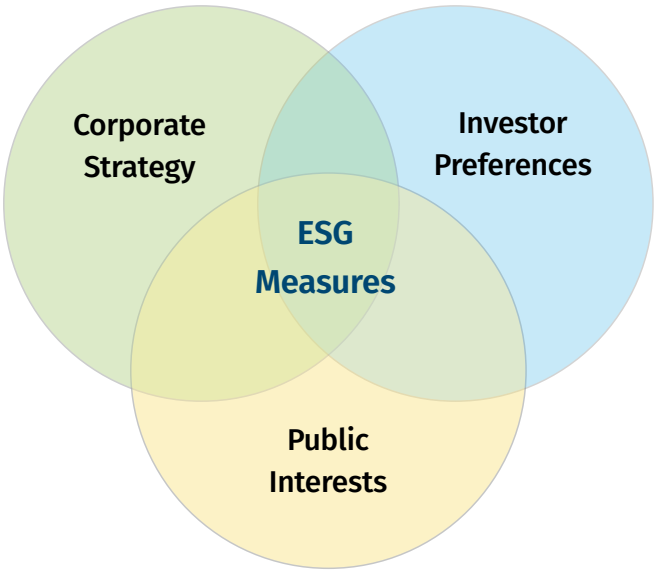
– Dr. Ronel Nienaber
Vice President, Global Reward, Benefits, and HRIS, Sasol, Sandton, South Africa

Context

While initial discussions on ESG measures have been broad, there has been an increasing focus on climate from investors (such as BlackRock), regulators or standard-setters (e.g., the Taskforce on Climate-Related Financial Disclosures), and shareholder activists. "Say on Climate" initiatives have seen companies pressured to submit annual non-binding advisory resolutions on their climate transition action plans. Regulators across regions are mandating that companies disclose information about their climate risks, GHG emissions, and transition plans.

Investors also are wrestling with how best to address the climate issue. For example, should they invest in carbon-intensive industries to support their decarbonisation transition efforts and engage with those companies through active stewardship or avoid investing in them entirely? And how to make this decision in light of the possibility of energy shortages that could hurt particularly vulnerable communities?

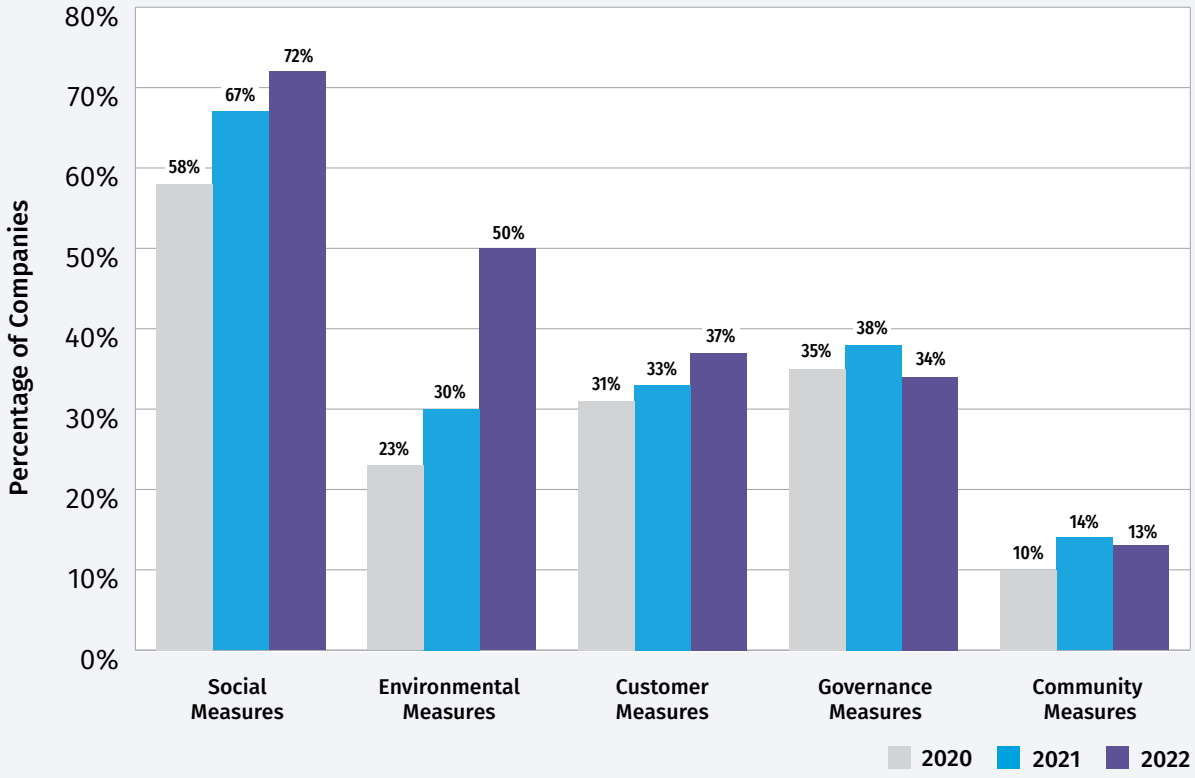
Some investors have their own emissions targets related to their investment portfolio, which can be in the form of absolute GHG emissions reductions or reducing emissions intensity (i.e., emissions per unit of production), sometimes targeting high-emissions sectors. These strategies in turn influence investors' policies on ESG incentives—for instance, Amundi and UBS Group both have policies that expect large companies in high-emissions industries (e.g., Oil & Gas) or exposed to climate change mitigation (e.g., Automotive) to use climate-related measures in their incentive plans.



Current State

- Social measures continue to be the most prevalent type of ESG measure used in incentives, gaining a further 5 percentage points since last year, from 67% to 72%
- Customer and governance measures are used by approximately one-third of companies, but have gained little in prominence
- Similarly, community-related measures are used minimally, possibly because the link back to financial materiality can be more difficult to affirm and/or investor and public pressures have focused more on environmental and employee metrics

Prevalence of ESG Incentive Measures by Type of Measure

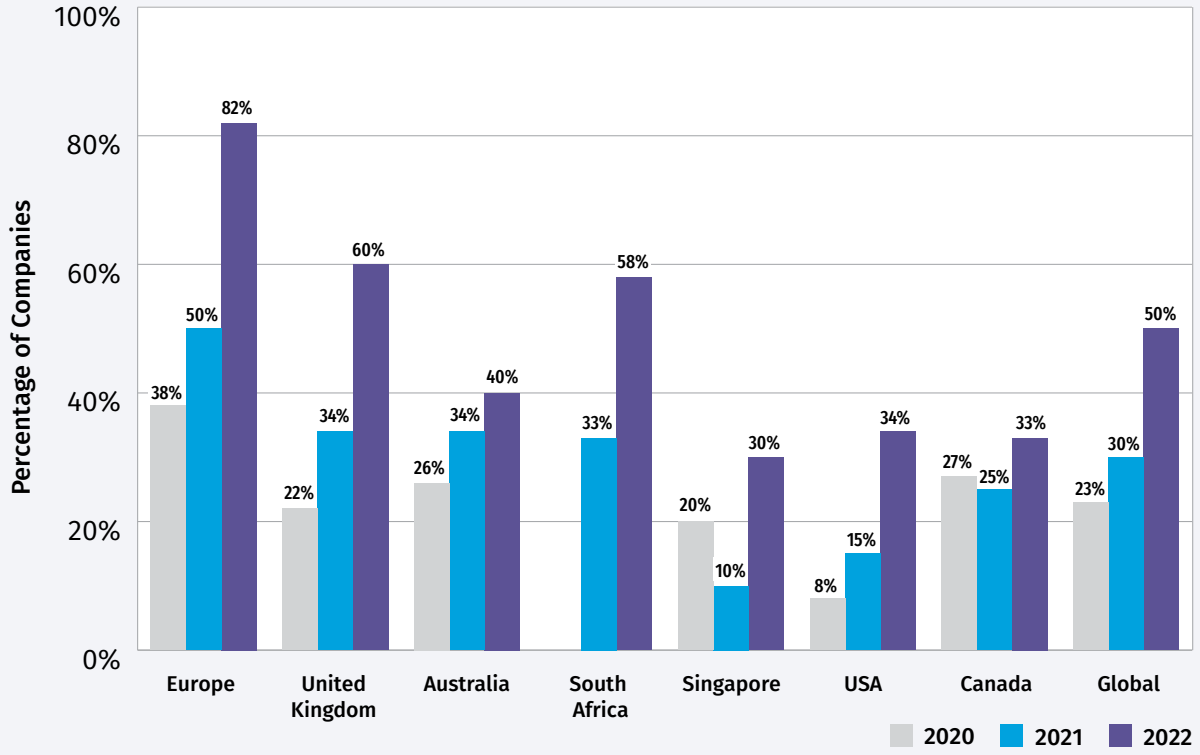


SELECT

Current State

- Environmental measures made the most significant gains in prevalence, up by 20 percentage points in one year from 30% to 50% of companies
- Europe leads in its use of environmental measures, with 82% of companies in the region now using such measures, an increase of 32 percentage points from 2021
- North America and Singapore lag the other markets in environmental metric use. Nevertheless, the U.S. has demonstrated increases, with environmental measures now used by nearly one-third of companies, up from 8% in 2020

Prevalence of Environmental Measures by Region



"While investors have long preferred financial metrics in remuneration, we are seeing that view change dramatically and hence it's inevitable that ESG-linked remuneration targets will become more prevalent."

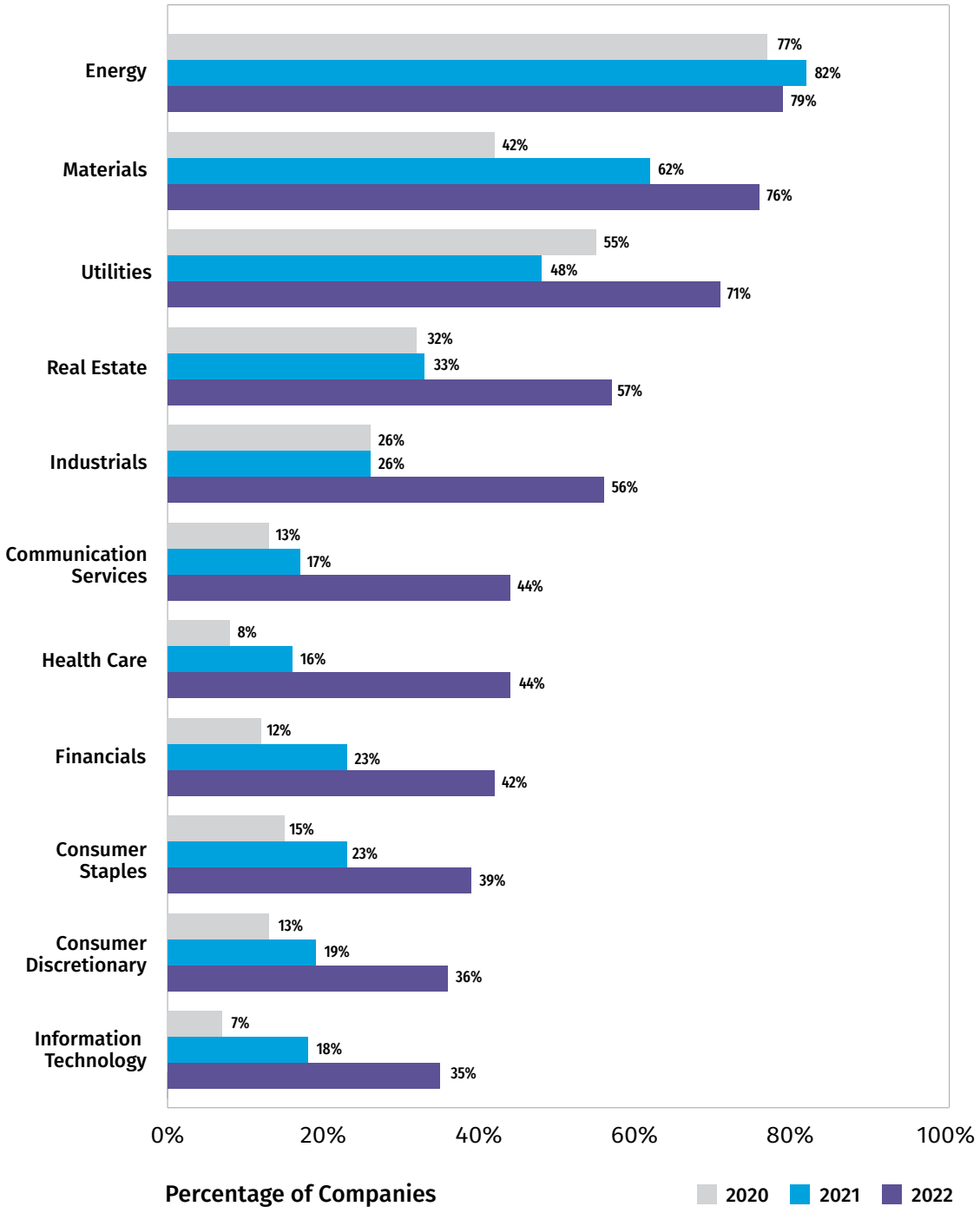
– Holly Kramer
Sydney, Australia
Non-Executive Director, Woolworths Group, Endeavour Group, Fonterra Co-operative Group

SELECT

Current State

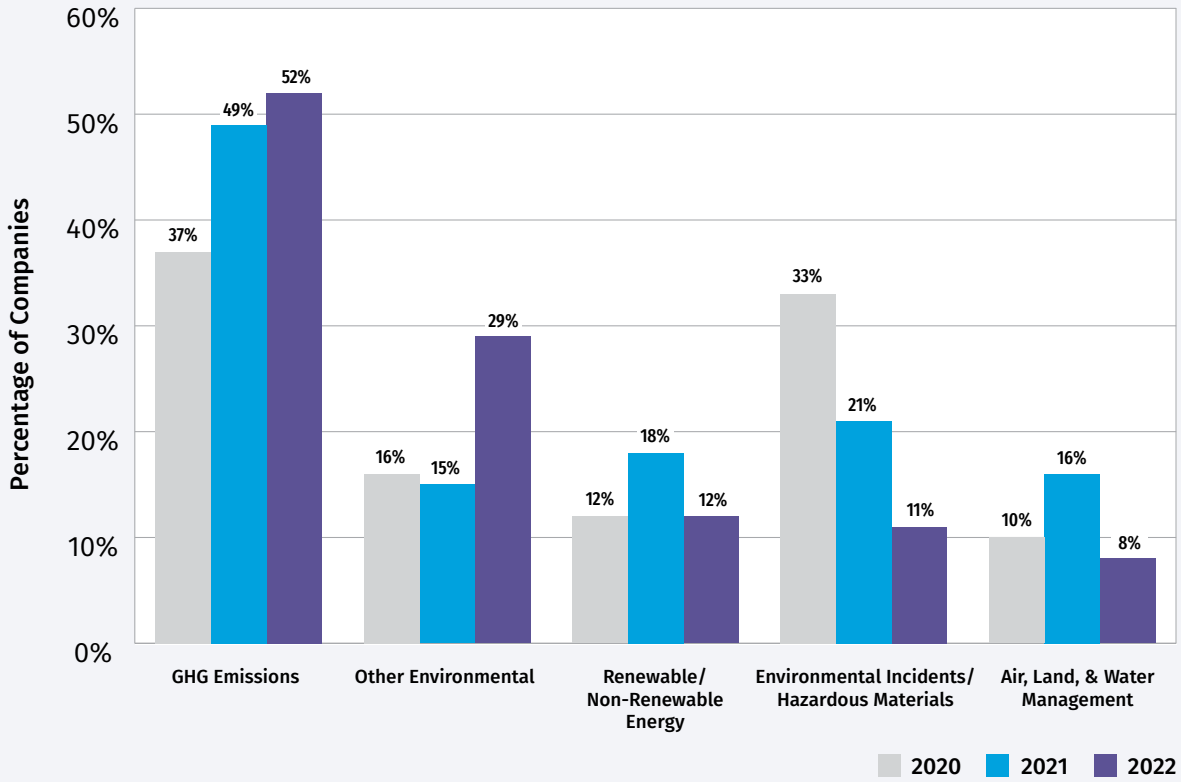
- The Energy sector continues to lead in the use of environmental measures in incentives, with 79% prevalence, which has not changed much from prior years
- 2022 showed much larger gains in environmental measures used than in prior years, indicating that the prevalence of environmental measures is broad across all business types

Prevalence of Environmental Measures by Sector



- Of those companies using environmental measures in incentives, about half are focusing on GHG emissions
- Outside of GHG emissions, companies also are using environmental measures tied to improvements in air quality, land management, and water conservation

Prevalence of Environmental Measures by Type Among Companies Using Environmental Measures



Predictions

- Investor pressure for companies to set long-term net-zero commitments and short-term emissions reduction targets will push companies to adopt measures in incentives that demonstrate their commitment to climate efforts, particularly GHG emissions
- Working groups such as the new Taskforce on Nature-related Financial Disclosures (TNFD), which goes beyond climate-related risks to address broader nature-related risks (such as land use and ocean and freshwater management), have begun to gain traction among policymakers and investors, with key stakeholders beginning to develop quantifiable metrics to measure progress. As these metrics firm up, we may see a reversal of the current trend of a decrease in the use of other environment-related measures beyond GHG emissions

Examples of Environmental Metrics

ANGLO AMERICAN (UK)
Anglo American's LTI award is weighted 8% on renewable energy production capacity, two additional sites above target to have execution stage approval and Latin America and Australia to have an approved Renewable Energy Ecosystem in place; and 6% weighted on reduction in abstraction of fresh water in water-stressed regions

ASTRAZENECA (UK)
AstraZeneca's long-term incentive (LTI) performance share plan includes a measure for "ambition zero carbon," which incentivizes the elimination of the company's Scope 1 and Scope 2 GHG emissions by 2025 with targets verified in line with the science of climate change

DEUTSCHE BANK (GER)
Deutsche Bank's LTI award bases one-third on an "ESG factor," comprised of generating 77 billion euros of business with environmentally sustainable finance and investments; using 80% of its own renewable energies; and lowering total building energy consumption by 10% from 2019 levels to 250 kwh/square meter

VERIZON COMMUNICATIONS (US)
Verizon's short-term incentive (STI) award is weighted 10% on diversity and sustainability measures, including a 10% reduction in the company's carbon emissions, calculated as [emissions divided by the terabytes of data transported over the company's networks]

"Companies should always assess the external environment to gain insight into the factors which may influence longer-term value. The board will then weigh these external factors in our overall assessment of future strategy."

– Yasmin Allen
Greater Sydney
Director, Australian Stock Exchange, Cochlear, QBE Insurance Group, and Santos

SELECT: The use of DEI measures continues to grow considerably and is now far ahead of other social measurement types

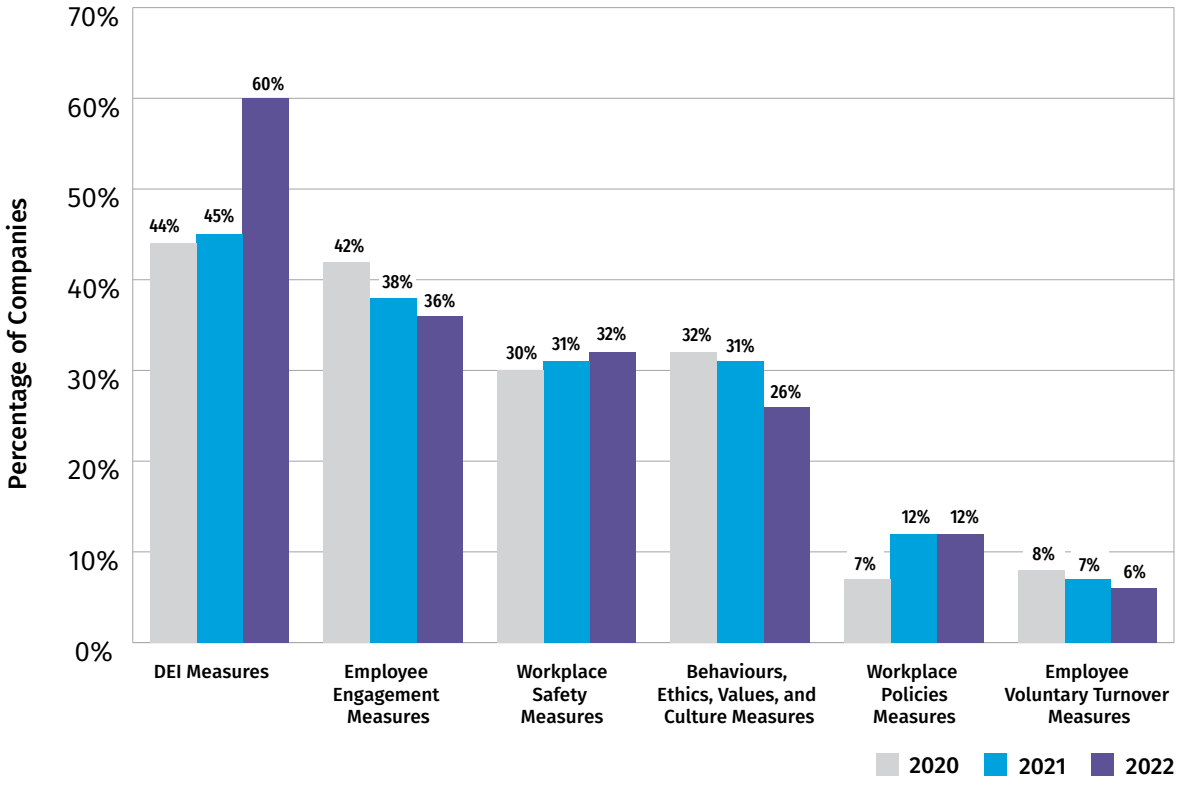
Context

Investors continue to focus heavily on social issues, primarily workforce diversity, which has driven up the use of diversity, equity, and inclusion (DEI) measures in incentive plans. In prior years, investor pressure focused on disclosure, pushing companies to publish their diversity metrics. But now, while the pressure on disclosure remains, there are expectations for companies to demonstrate progress on their gender and/or racial and ethnic diversity, particularly for companies that may be lagging relative to others in their industry.

Current State

- Globally, 60% of companies using social measures in incentives focus on diversity, up 15 percentage points from last year

Prevalence of Social Measures by Type Among Companies Using Social Measures



ADOPT

Predictions

- Social measures will continue to capture needed improvements that indicate how the business is living its values, how it is achieving competitive advantage by employing a diverse workforce, and/or how it is preserving value through such measures as safety
- DEI measures will continue to be a primary social measure given the relative ease with which performance can be measured
- DEI measures will increase in prevalence as companies develop and refine their DEI strategies with more specific objectives and targets

"Diversity" means different things in different places. As such, ESG measures on DEI vary across markets

Diversity can be measured across many different variables, including age, gender, race, ethnicity, sexual orientation, language, geography and religion. In the context of corporate board and workforce diversity, the term typically refers to gender, racial, or ethnic diversity, but can sometimes be broader as well. Moreover, the relevant diversity categories vary globally due to differences in regional demographics and cultural norms.

In recognition of these differences, when the Nasdaq stock exchange released listing standards in 2021 requiring companies to disclose board-level diversity statistics, the acceptable disclosure matrix differed among U.S. and non-U.S. issuers. For the U.S., the matrix included categories for gender, race, ethnicity, and LGBT status. Meanwhile, for non-U.S. issuers, the matrix included categories for gender, LGBT status, and a broader category for executives that identify as "underrepresented" in their home country based on national, racial, ethnic, indigenous, cultural, religious, or linguistic identity.

With myriad ways to define diversity, companies have taken different approaches when tying ESG incentives to diversity. In the U.S., South Africa and the U.K., there is an inclination to use measures of gender, racial and/or ethnic diversity, whereas in other markets, there is an inclination to put greater focus on gender diversity. Additionally, some companies also use references to "underrepresented minorities" without specification to include a broader set of employees with low representation extending beyond racial or ethnic groups, like the Nasdaq rules.

Examples of DEI Metrics

CREDIT SUISSE

CREDIT SUISSE (SW)
Credit Suisse's short-term incentive (STI) award is tied to diversity and inclusion achievements, with goals to reach female representation among managing directors (MDs) of 25%, increase overall female representation, increase underrepresented talent globally, and increase Black talent in their U.S. and U.K. operations

orange™

ORANGE SA (FR)
Orange's STI award is tied to key changes in HR indicators, including the percentage of women represented in management networks

TEXTRON

TEXTRON (US)
Textron's STI award is tied to "Hiring Diversity Performance", which represents the percentage of full-time U.S. salaried newly hired employees who identify as female or diverse based on race or ethnicity, with goals of 33.4% at threshold, 43.4% at target, and 47.1% at maximum performance

INCORPORATE: ESG incentives are increasingly being incorporated into long-term incentives

Context

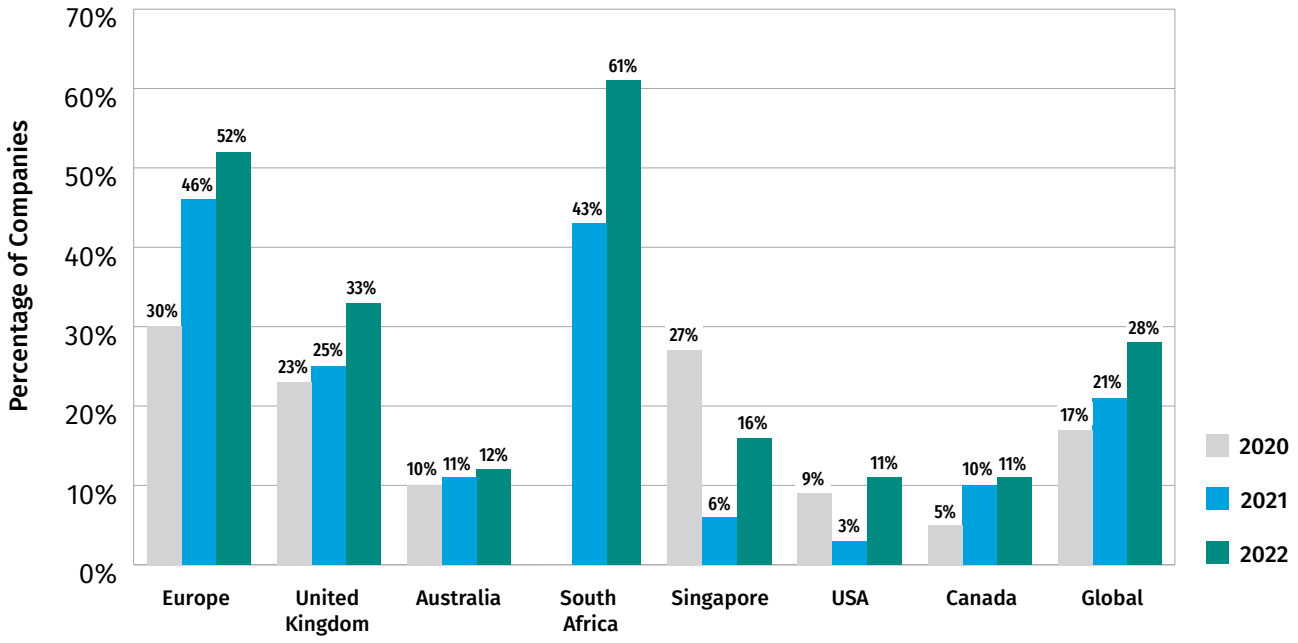
ESG measures in compensation have typically been adopted in short-term incentive (STI) plans because these plans have traditionally been the "home" for other non-financial measures (e.g., strategic, operational, and individual). In addition, since many ESG strategies and the underlying measures are in development, it remains difficult for many companies to define measures and set goals over the longer term, making it helpful to "pilot" ESG measures and goals in the short-term plan.

Nevertheless, given the long-term nature of many ESG measures and targets (e.g., net zero by 2050), it can be appropriate to consider these measures for long-term incentive (LTI) plans. Long-term sustainability plans can span decades, so companies often break down long-term aspirations into interim milestones to capture progress on ESG measures. Given the architecture of most LTI plans, this break-down most often comes in the form of three-year goals, though some may use four or five years.

Current State

- More than one-quarter (28%) of global companies with ESG measures now use those measures in their long-term incentive plans, which represents an increase of 11 percentage points from 2020
- South Africa (61%), Europe (52%), and the U.K. (33%) have the highest prevalence of ESG measures in their LTI plans, and represent the regions in which prevalence has increased
- The increasing use of ESG measures in LTI plans in Europe and the U.K. likely coincides with the regulatory pressures in the region aiming to address environmental matters, and a recognition that environmental plans are typically long-term in nature
- Companies in countries such as the U.S., Canada, and Australia have demonstrated a slower uptake in the use of ESG measures in their LTI plans. This might be due to differences in investor expectations, regulations, and/or cultural norms across regions

Prevalence of ESG Measures in Long-Term Incentive Plans Among Companies Using ESG Measures



Predictions

- As more companies develop climate strategies and gain greater confidence in measuring ESG performance, ESG measures will become more prevalent in long-term incentive plans
- Regional and sector dynamics may accelerate or provide a brake to adoption of ESG measures in long-term incentive plans (e.g., heavy emitters will have higher adoption rates reflecting regulatory pressure, where U.S. companies will have lower adoption rates reflecting political and cultural pressure)

Examples of LTI ESG Metrics

AGL ENERGY (AU)
AGL Energy uses a Carbon Transition (CT) measure, weighted 25%, in its LTI plan. This measure comprises three sub-metrics with quantitative goals, all measured over a four-year performance period ending in 2025. The sub-metrics are emissions intensity, percentage of renewable and storage electric capacity, percentage of revenue derived from green energy and carbon-neutral products and services

AVIVA PLC (UK)
Aviva's LTI plan includes measures for reduction in CO_2 intensity of shareholder assets (weighted 5%), females in senior leadership roles (weighted 2.5%), and ethnically diverse employees in senior leadership roles (weighted 2.5%). The measures include a threshold to maximum range of specific quantitative targets and are measured over a three-year performance period

GOLD FIELDS LTD. (SA)
Gold Fields' LTI plan includes an ESG component, weighted 25%, split evenly between measures for decarbonization and gender diversity and inclusion across the group, each measured over a three-year performance period

"Stakeholder incentives need to be integrated into strategy, business, and budget planning, and into group, department, and personal goals and reviewed throughout the year just like other goals."

– Eric Wetlaufer
Managing Partner, TwinRiver Capital, Toronto; board member of TMX Group, IMCO, Enterra Solutions, and Niyogin FinTech

INCORPORATE: ESG incentive measures are increasingly quantifiable

Context

There continues to be an evolution in the emphasis and rigour of ESG measures within the incentive structure. In the early stages of ESG strategy development, many companies incorporated general and more qualitative sustainability measures into incentives to demonstrate their importance, while also recognising that specific measures and targets were sometimes not fully established.

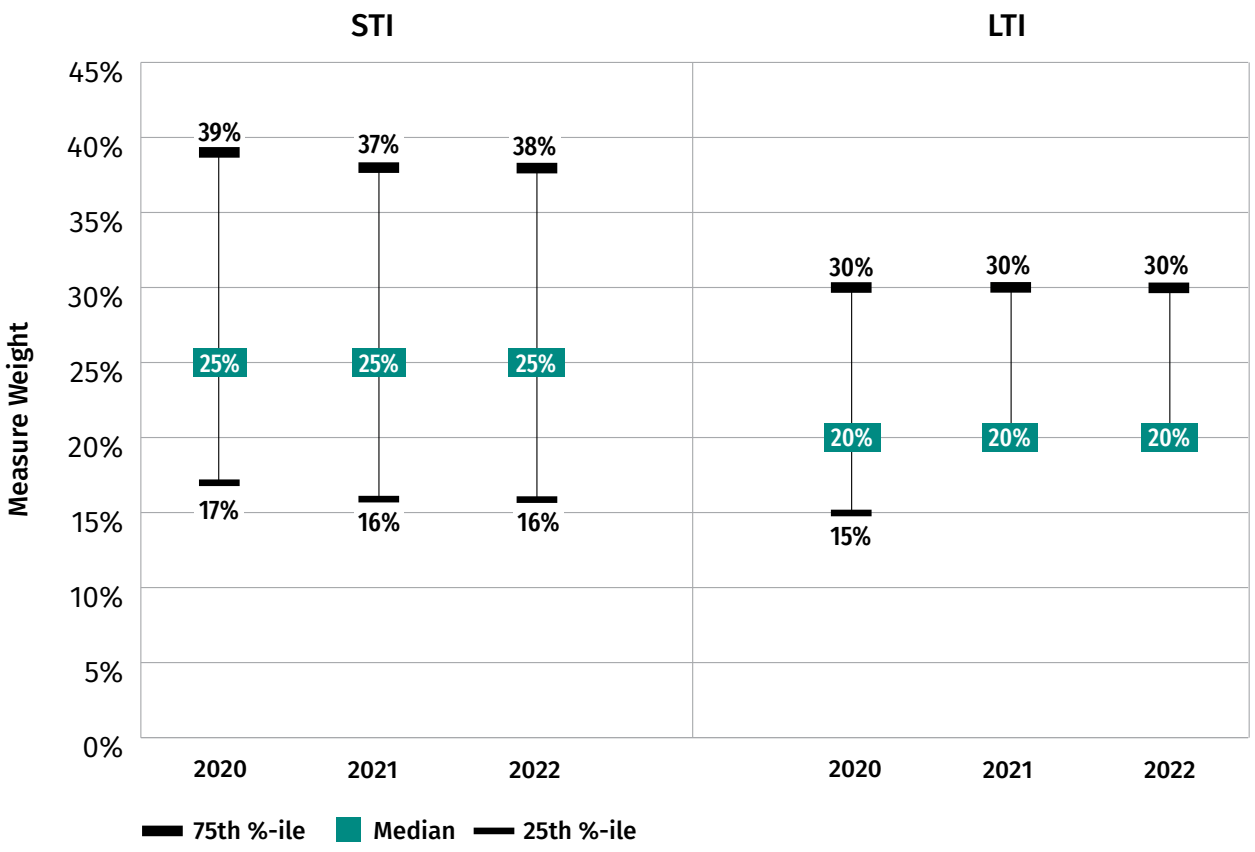
Investor pressure has forced more companies to migrate from only qualitative or "soft" measures to more quantitative goals. For example, a company that used disclosure of GHG emissions as an activity-based goal in a prior year may be switching to a quantitative GHG emissions reduction goal in its new incentive plan design, which builds upon prior efforts to disclose its data and establish baselines.

Additionally, many boards and their directors have become more comfortable with ESG measures as their companies invest in data tracking and auditing mechanisms. This in turn, provides greater confidence in setting longer-term quantitative targets and to agree on specific weighting for these targets.

Current State

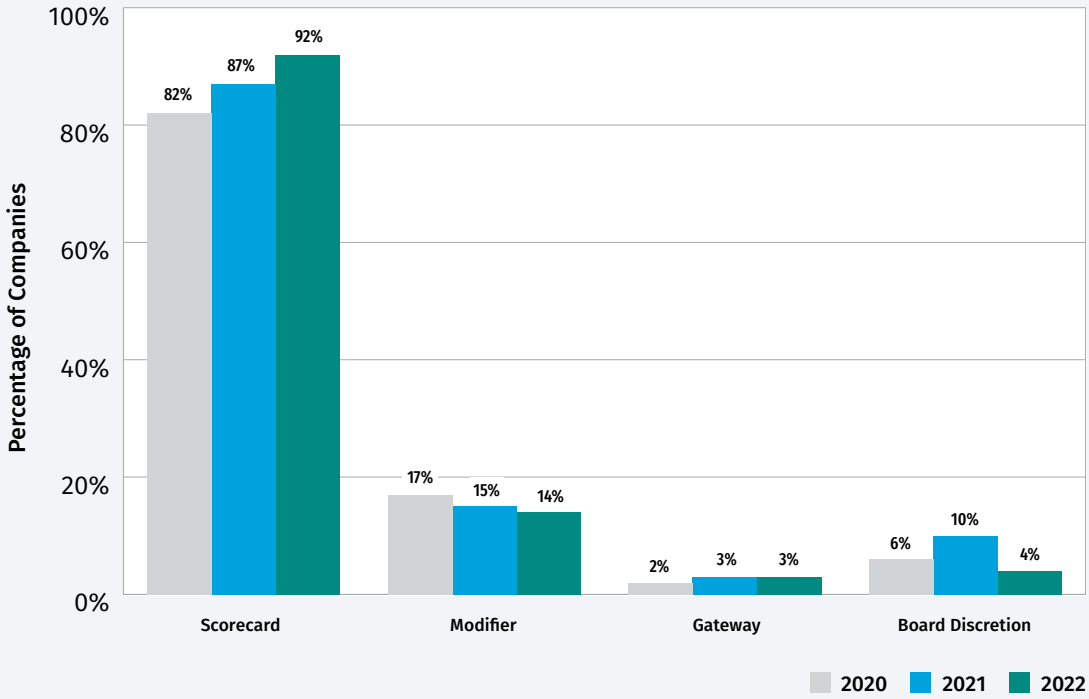
- When used, ESG measures in aggregate continue to be weighted about 25% in short-term and 20% in long-term incentive plans

Weighting of ESG Measures in Incentive Plans

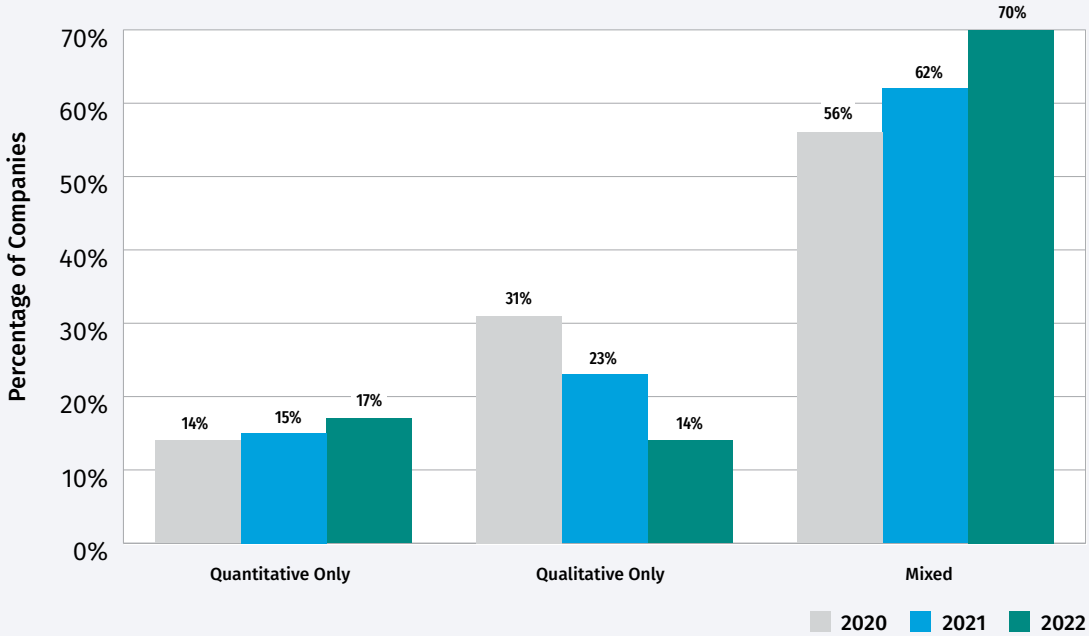


- Most companies (92%) use a scorecard through a weighted or discretionary approach to incorporate ESG measures into incentives
- Use of ESG measures as a modifier is decreasing as companies coalesce around scorecard or weighted approaches. Almost three-quarters of companies using ESG measures use at least one quantitative measure, an increase from prior years
- Only about 14% of companies that disclose their ESG measurement mechanism use strictly qualitative ESG measures in their incentive plans, which represents a 17 percentage point decrease from 2020, as companies adopt more quantitative goals

Mechanisms for Incorporating ESG Measures Into Incentives Among Companies Using ESG Measures



Prevalence of Quantitative vs. Qualitative Measures Among Companies Using ESG Measures and Disclosing Measurement Type



Predictions

- There will be greater use of ESG measures in compensation with discrete weightings (within or outside of scorecards) as organisations continue to prioritise key ESG measures that are critical to the business
- ESG measures used in long-term incentive plans likely will appear in the form of quantified weighted measures, rather than embedded with other metrics in an unweighted scorecard
- There will be increased quantification of measures with specific measurable goals disclosed
- The overall weighing of ESG incentives will increase in the total pay mix as they are added to LTI plans

Examples of Quantitative/Qualitative ESG Metrics

ASCENA REIT (SG)
Ascena REIT's STI plan uses a balanced scorecard with performance outcomes based on quantitative and qualitative targets across various dimensions including "sustainability," which relates to measures for talent retention, succession planning, and sustainable corporate practices

EMERA ENERGY (CA)
Emera Energy's STI plan includes categories for safety (weighted 10%), environment (weighted 10%), and people (weighted 10%), which in turn, encompass various qualitative and quantitative objectives, such as implementing new safety training modules, achieving a 50% employee completion rate, establishing key DEI metrics and baselines, and improving the company's employee engagement survey results

SAP (GER)
SAP's STI plan includes three quantified "sustainability KPIs" encompassing Customer Net Promoter Score (weighted 6.67%, target +5 to +10), employee engagement index (weighted 6.67%, target 84%), and net carbon emissions (weighted 6.67%, target 145 kt CO_2)

VERIFY: More work is needed to set rigorous targets and make ESG incentives a meaningful portion of overall pay

Context

As companies began to use ESG incentives, investors questioned whether they were willing to pay executives for performance under these non-financial measures, particularly if the measures were more qualitative and/or tended to pay out above target or better than financial measures. There have been criticisms from some investors and others that ESG measures may be used to pad or increase incentive payouts or to make up for less than stellar financial performance by the company. In response, companies are adopting more rigourous processes to establish performance targets that reflect a mix of strategic expectations, relative performance among peers, and historical trending.

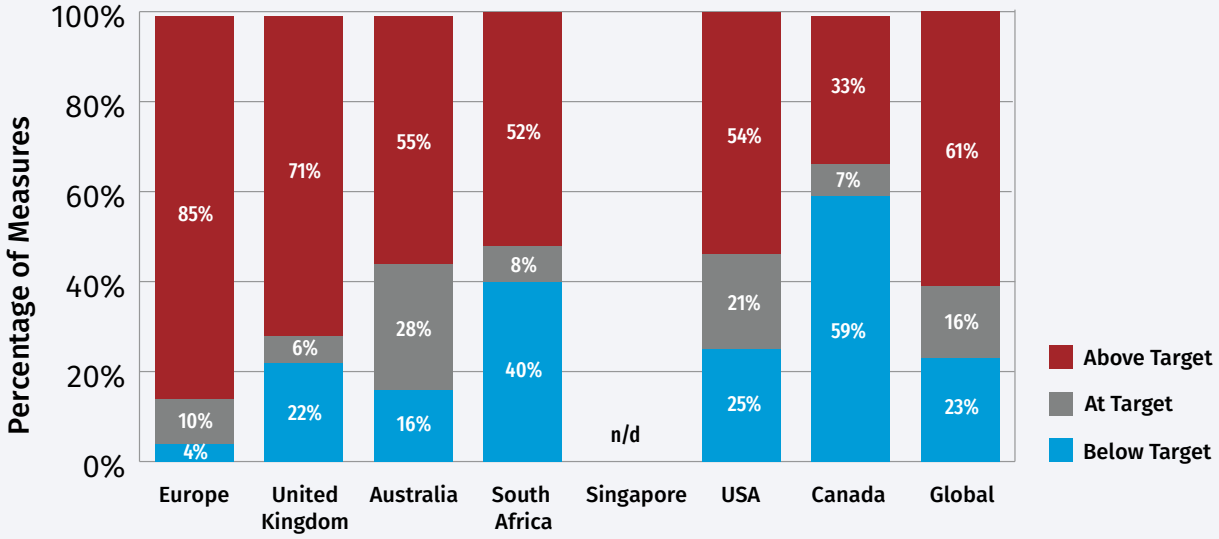
"What is not measurable is not easily managed or monetised. Fair wages, healthy products, customer health, affordability and accessibility, workforce health, equity—we need it all but none of these have a unit measurement. It is the intangible economy that we need most but does not work for the capitalist system in the U.S. I think these goals should not be discarded. But comp plans with these goals will be targeted. Most will be very hard to administer."

– Jeffrey W. Ubban
Founder, Inclusive Capital Partners, San Francisco;
Director, ExxonMobil, Fertiglobe, and Enviva

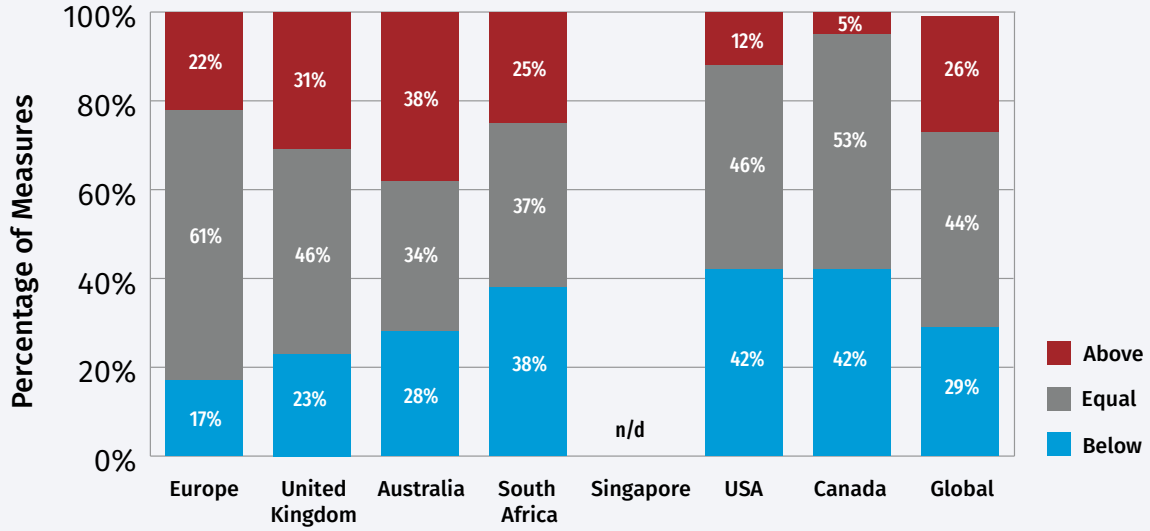
Current State

- Overall, 61% of ESG measures pay out above target, 23% pay out below target, and 16% pay out at target
- However, payout levels vary considerably by region. For example, most measures used by European companies (85%) pay out above target, while most used by Canadian companies (59%) pay out below target
- When comparing how ESG measures pay out relative to overall STI payouts, nearly half of the measures (44%) pay out at the same rate, while a similar portion pay out at above (26%) and below (29%) the overall rate

Payouts as a Percentage of Target For ESG Measures In Short-Term Incentive Plans By Region



Payouts For ESG Measures Relative to Total Payouts for Corresponding Short-Term Incentive Plan By Region



VERIFY

Predictions

- Companies will increasingly face investor scrutiny to explain their ESG measures, justify their goals, and warrant their results
- As goals become more quantified, payouts for ESG measures will become increasingly distinct from those for financial and other types of measures

Examples of Disclosures on Payouts for ESG Performance

AFRICAN RAINBOW MINERALS (SA)
African Rainbow Minerals' LTI plan includes sustainable business measures for improved safety performance, improvement in Broad-Based Black Economic Empowerment (B-BBEE) score, and environmental compliance based on various climate change performance targets for reductions in Scopes 1 and 2 GHG emissions. The payouts achieved on these metrics in 2021 were between target and maximum performance levels

DEXUS (AU)
Dexus' STI plan weights ESG measures 25%. The plan paid out at varying levels for different metrics. Its Customer Net Promoter Score (NPS) paid out above target for outperformance (target of +41 to +45, with actual achievement of +46); its safety audit score paid out above target for outperformance; its employee NPS paid out at target (target of +41 to +45, with actual achievement of +43); and its performance against four ESG benchmarks (PRI, GRESB, DJSI and CDP)[1] paid out above target

IBM (US)
IBM uses a diversity modifier in its annual incentive plan based on improvement in the representation of executive women globally and of Black and Hispanic executives in the U.S. Due to improvement in representation across all targeted groups, the diversity modifier increased the incentive payout by five percentage points

(1) Principles for Responsible Investment (PRI); Global Real Estate Sustainability Benchmark (GRESB); Dow Jones Sustainability Index (DJSI); Carbon Disclosure Project (CDP)

To effectively oversee stakeholder interests, boards and compensation committees can consider the following questions at the four different stages of the ESG journey:

ADOPT

- Does the company have a credible strategy that includes stakeholder interests?
- Does the company have measures and goals that indicate real progress and corporate sustainability?
- What do your investors and other stakeholders think about the company's commitments, measures, and goals?
- Is the company making any direct or implied ESG promises it can't keep?

SELECT

- Do the ESG measures align with the company's business strategy?
- Which measures have the greatest impact on sustainable performance and culture?

INCORPORATE

- Has the company established credible ways for delivering on and measuring performance?
- Have baseline performance levels been developed?
- Over what time period can meaningful progress be made?
- How should ESG incentives be structured (e.g., scorecards vs. weightings, quantitative vs. qualitative, short- vs. long-term, activity- vs. outcomes-based)?

VERIFY

- Who on the board has responsibility for setting ESG goals and verifying performance? What role for other functions within the company to verify?
- Does the compensation committee have the information it needs to effectively determine achievement levels and translate achievements into payouts?

Action Steps for Directors

Boards have a critical role to play in all four stages of the ESG incentive journey, i.e., determining whether to **adopt** ESG incentives, and if so, which measures to **select**, how best to **incorporate** such measures into the plans, and how to establish goals and **verify** results. The last stage contributes to stakeholder trust that ESG measures are being taken seriously. To help strengthen the board's role, boards should consider the following actions:

FIVE ACTIONS FOR BOARDS TO CONSIDER

1. Ask the right questions (see sidebar)
2. Identify measures that are derived from the strategy and can move the needle on sustainable performance
3. Consider the use of ESG measures not only in short-term but also in long-term incentive plans
4. Take a broad perspective in considering the use of ESG measures, e.g., use of measures inside as well as outside of incentives, alignment up and down the organisation, messaging in all types of company communications (internally and externally), impact on culture, and comparisons with peer and most-admired companies
5. Review board governance of ESG matters to ensure effective oversight. Ensure that governance responsibilities are assigned and overlapping, as needed, to avoid gaps or lapses

RECAP

- Environmental and diversity measures will continue to gain traction as definitions around these measures improve
- Companies will continue to gain confidence in measuring ESG performance, which will open the door to greater use of ESG measures in LTI plans
- Regulators put greater pressure on companies to report on their ESG plans, goals, and achievements, scrutinising companies for quantification and validation of results
- Investors will sharpen their stance on the use of ESG measures in executive incentives with companies facing greater scrutiny on the extent to which their measures reflect their strategies and their payouts reflect real, quantifiable achievements

Contact Us

We hope this research is illuminating and contributes to continuously improving corporate and stakeholder engagement.

We invite your questions and comments. Please direct all inquiries to GECN Group leadership or write to **international@gecn.com**.

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