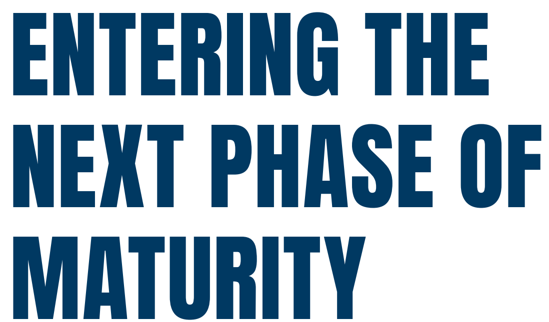
GLOBAL TRENDS IN ESG INCENTIVES:



Guerdon Associates
Remuneration & Governance
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A Note from the GECN Group Chair: The global reach of the GECN Group allows us to look at major governance, compensation, and related challenges without geographic constraints. No topic today benefits as acutely from this vantage point as the topic of sustainability or ESG.

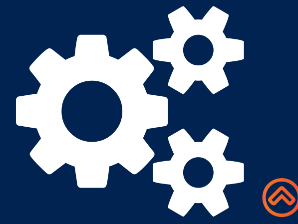
Our 2023 report captures emerging concerns, tensions, and a level of "what's next?" nervousness among company leaders, as well as clear further evidence of no turning back: ESG has established itself as a strategic though challenging topic for companies across all regions.

On behalf of our staff and leaders across five continents that make up the GECN Group, I invite you to engage in our report and to reach out to us if the subject is of interest to you, your company or your investors.

- *Gabe Shawn Varges*
  Chair, GECN Group

Guerdon Associates Pty Ltd (www.guerdonassociates.com) is an independent consulting firm that provides remuneration and governance services that contribute to improved and sustainable shareholder value. As a founding member of the GECN Group we bring together behavioural, financial and legal disciplines, comprehensive data and research, a measurement framework, and global knowledge and reach to achieve this regionally, nationally and internationally.

The Global Governance and Executive Compensation (GECN) Group is comprised of the world's leading independent firms specializing in executive compensation, performance management, and governance. The GECN Group serves hundreds of companies employing millions of employees 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

Being aware of longer-term trends is critical for companies as they prepare for the future and formulate corresponding strategies, this year's seventh annual research report by the Global Governance and Executive Compensation (GECN) Group is entitled **2023 Global Trends in ESG Incentives: Entering the Next Phase of Maturity.**

As ESG advances as a corporate and even regulatory topic, how is this affecting pay practices? What specific choices on targets and metrics are companies making? Our research details trends across regions and industries. We trust it provides timely insights and data useful for corporate decision-makers as they design their ESG and compensation strategies.

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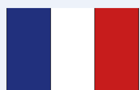
STUDY METHODOLOGY

Australia - ASX 100

Canada - TSX 60

Continental Europe


• France - CAC 40

• Germany - DAX 30

• Switzerland - SMI 20

Singapore - STI 30

South Africa - JSE Top 40

United Kingdom - FTSE 100

United States - S&P 100

Global in scope, this year's research covers Australia, Canada, continental Europe, Singapore, South Africa, the U.K., and the U.S. The GECN Group analyzed data* on ESG incentives from the most recent public disclosures of all 500+ companies listed in the following indexes.

NEW THIS YEAR

We've expanded coverage to the U.S. S&P 1500 Index to analyze differences among large-, mid-, and small-cap companies.

*For this year's report we supplemented our data, with data collected on our behalf by ESGUAGE.

For the purposes of our analysis, all ESG-related measures were grouped into the following categories:

CATEGORIZATION OF ESG INCENTIVE MEASURES

SOCIAL

- Diversity, Equity & Inclusion (DEI)
- Workplace Safety (e.g., fatalities, injuries, exposure to harmful substances)
- Employee Engagement
- Employee Voluntary Turnover
- Workplace Policies
- Other Social (e.g., training and development)

ENVIRONMENTAL

- GHG Emissions (e.g., Scope 1, 2, and/or 3)
- Renewable or Non-Renewable Energy Use
- Environmental Incidents / Hazardous Materials
- Air, Land, and Water Management
- Other Environmental

CUSTOMER

- Customer Satisfaction (e.g., Net Promoter Score)
- Product Quality and Safety
- Responsible Sourcing
- Other Customer

COMMUNITY

- Philanthropy
- Human Rights
- Stakeholder/Community Engagement
- Other Community

GOVERNANCE

- Compliance
- Behaviours, Ethics, Values, and Culture
- Cyber Risk / Data Governance and Privacy
- Other Governance

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EXECUTIVE SUMMARY

ESG has entered a new phase. Corporate sustainability – once a niche focus among some stakeholder-aligned businesses – experienced a wave of interest amid a dramatic shift in expectations of what corporations owe society in recent decades. We are now entering a more sober stage. Stakeholders are making their ESG demands on companies more exacting, and companies need to figure out how best to meet these demands, while facing new crosswinds with differences in perspectives, including in the U.S.

First, strains are emerging related to timing. ESG strategies have a long-term orientation (e.g., net zero by 2050) yet require now significant time, capital, and resource allocation, creating tensions with the shorter-term needs and views of some investors. These strains have been exacerbated by global responses to inflation, impacting economic growth and opportunity, and by concern with the costs of implementing ESG standards and escalating governmental regulations on the subject.

Differences on the “how” are also appearing. Even among those sharing the same concern for the planet, there can be legitimate differences on the degree, speed, and type of initiatives that are most beneficial. Could a high focus on electrification (i.e., the move from combustible engines to electric motors) crowd out other viable alternatives to reduce emissions? And can electrification be at the cost of other worthy sustainability targets, such as reducing mining activity to preserve forests and promote biodiversity?

Similarly, in the social area, new tensions are beginning to surface. For instance, ESG-engaged companies are having to justify their ties to countries with poor human rights records. Regulators are becoming wary of enterprises seeking to leverage their ESG credentials commercially amid rising concerns about green-washing. In the investment arena, for example, this has led some regulators to warn that ESG investing may not necessarily be safe or represent lower risk than traditional investing.[1]

Companies are having to carefully navigate these cross-tensions and competing perspectives. And yet—the above notwithstanding—our findings this year suggest that enterprises are not decelerating their efforts to incorporate sustainability in their purpose and business activities. Rather, they are refining their ESG strategies in an ongoing pursuit of longer-term stakeholder value. As compensation and governance experts, the question we ask: “If companies need to demonstrate the link between ESG objectives and value creation, how can the compensation system help?”

UNDERSTANDING THE FINDINGS

Our 2023 report confirms a pattern from earlier years. There is a continuing upward trend in companies employing ESG measures in their compensation systems with differences by region, sector and company size. To enhance the analysis, we reviewed the data using a framework of the four primary categories that represent ESG incentive design. They are adopt, select, incorporate and govern, and represent areas companies need to consider when aligning compensation with ESG priorities.

To augment our research, we gathered the views of board directors, investors, and corporate governance experts from across the GECN countries which have been embedded throughout the report.

[1] The German Federal Financial Supervisory Authority has also warned consumers to not necessarily expect that ESG investments will deliver better long-term returns.

ESG INCENTIVE DESIGN CATEGORIES

As companies consider the use of ESG measures within their incentive plans, there are several elements for consideration, as outlined below.

ADOPT

To what extent is an ESG strategy integral to our company's purpose?

Are we clear on our ESG strategy? Is it about ESG in general or about a specific component?

Are we ready to incent ESG progress?

SELECT

Which ESG measures are most likely to advance our ESG strategy?

Of these, which will create or protect the most value?

What are our peers using as ESG incentives?

INCORPORATE

Should we incorporate measures into the short or long-term incentive? In both?

How can we define the measures qualitatively or quantitatively?

What emphasis should the ESG measures have?

Are the targets being set demanding enough?

GOVERN

Is the Board approving and providing oversight of the ESG strategy and the ESG incentive measures and targets?

How does our ESG performance compare to that of our peers?

How is assurance being achieved on the quality of ESG data, the meeting of targets, and ESG reporting?

KEY FINDINGS

The following summarizes the high-level findings of this research. On the surface, we see continuing trends, but there are differences emerging by region, sector, and company size. These differences are important for understanding approaches to planning and designing ESG incentives.

ADOPT

While close to 90% of large global companies have adopted ESG incentive measures, there is still variation by region, sector and size of company, reflecting different stages of maturity, readiness and stakeholder expectations.

SELECT

Environmental incentive measures continue to be adopted at a rapid pace, with greenhouse gas (GHG) emissions emerging as the primary metric. Social measures remain prevalent with a majority of companies adopting DEI metrics, such as greater gender or ethnic representation. Companies continue to adopt multiple rather than single ESG measures as they identify and prioritize what is most material.

INCORPORATE

ESG incentive measures are increasingly being incorporated into long-term incentives (LTI), while still primarily used in short-term (STI) incentive plans. Companies increasingly use a mix of qualitative and quantitative ESG measures. The overall weight of ESG measures hovers between 20-25% of the incentive opportunity, consistent with prior years.

GOVERN

Payouts for ESG incentive measures tend to deviate above/below the overall short-term incentive award, suggesting increased focus on setting real ESG targets.The overall weighting of ESG measures as a percentage of total compensation continues to increase given the higher prevalence in long-term incentives.

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ADOPT

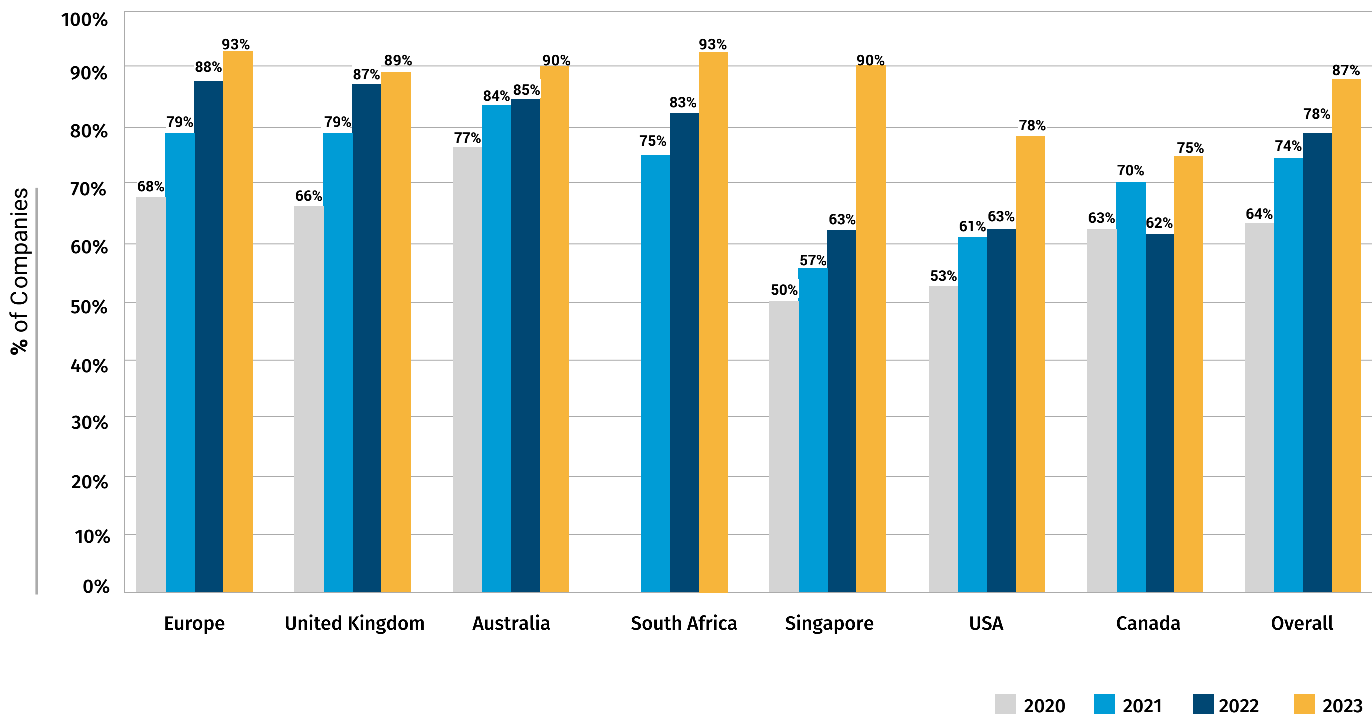
THE ADOPTION OF ESG MEASURES CONTINUES TO INCREASE, WITH SIGNIFICANT VARIATION BY REGION, SECTOR, AND SIZE OF COMPANY

CONTEXT: ESG has been undergoing an evolution. Many companies went through an initial "check the box" exercise to make some connection of ESG compensation. Later more solid connections could be observed as usage increased all sectors.

This year our study suggests that some companies are taking a more measured approach. Some are still working on their ESG strategy and identifying the ESG issues material to them. Others are working to sharpen their measurement tools and oversight processes and create baseline levels of performance. Since compensation decisions need to follow and not lead strategy, this is important work.

But it also means that the adoption of ESG measures may not continue to increase at the rapid rate witnessed in the past few years, particularly among the largest companies. These larger companies may be pausing to consider if or how best to incentivize ESG through the compensation system while smaller companies will likely see greater rates of adoption.

Prevalence of ESG Incentive Measures by Region



"Boards need to be pragmatic and focused on doing good for the business. It takes strength to resist pressure to do everything which is difficult as everyone has different priorities. We have the duty to look after the resources that have been entrusted to us and to use them in the way we believe is best."
-Jo Mark Zurel, Board Chair, Fortis Inc.

ADOPT

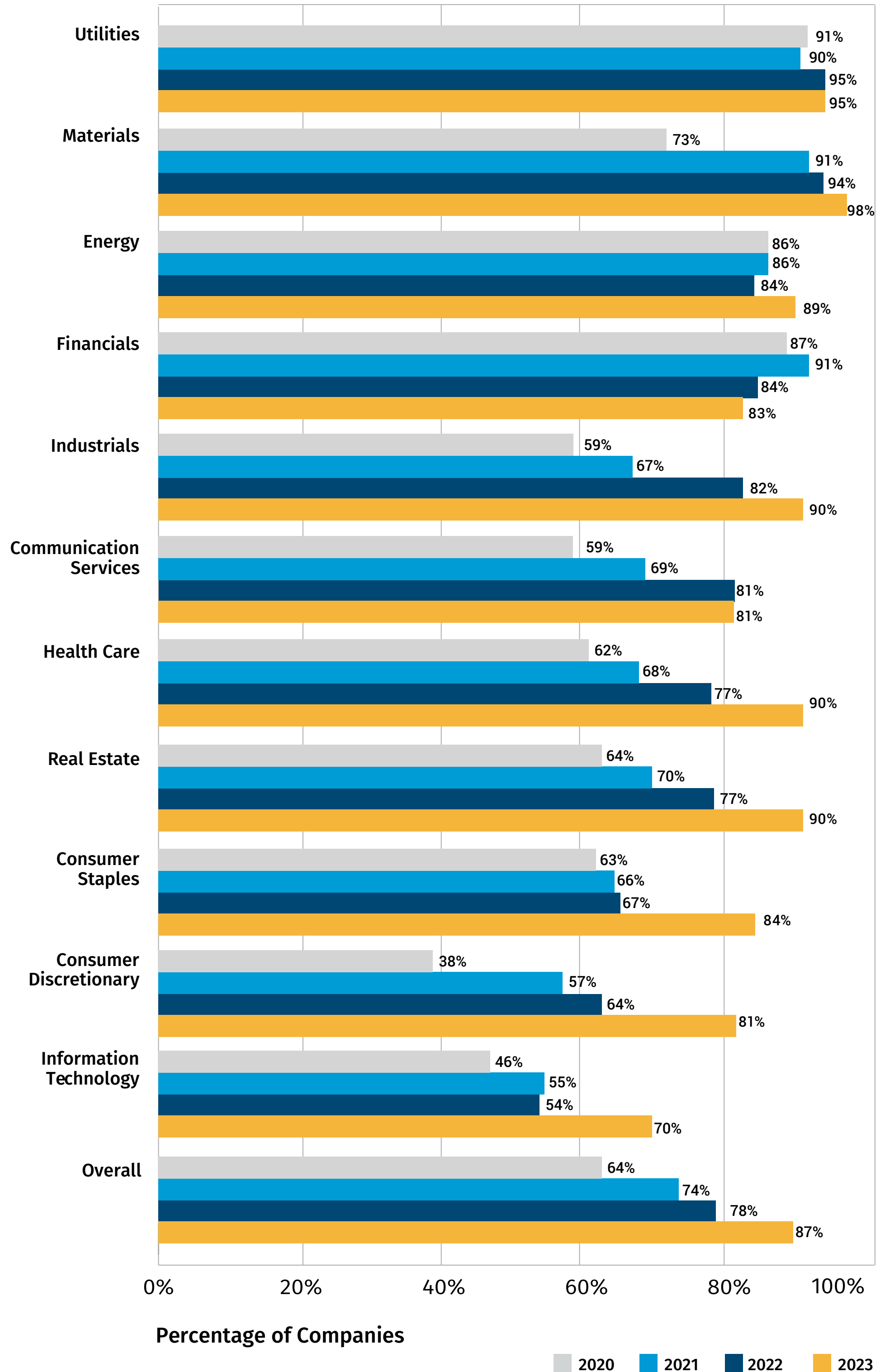
Prevalence of ESG Incentive Measures by Sector

CURRENT STATE:

- Close to 90% of companies incorporate ESG measures into their incentive plans up 9 percentage points
- Largest year-over-year increases were found in South Africa (+ 10pp), Singapore (+ 27pp), U.S. (+ 15pp) and Canada (+ 13pp) while the rest of the regions were relatively flat
- Sectors with previously low use of ESG measures (IT and Consumer) are catching up to the early adopters (Energy, Utilities and Financials)
- Clear difference between the largest and smallest companies with the majority of mega/large cap companies and only one-half of the mid/small companies adopting ESG measures into their incentives

"Remuneration follows strategy, therefore it is important that ESG is organically understood and implemented throughout the business before it can be included in pay."

Dr. Ronel Nienaber, Vice President Global Reward, Benefits & HRIS, SASOL



PREDICTIONS

#1 Modest growth in sectors / regions with high adoption rates (greater than 90%) and/or in regions with increasing ESG pushback.

#2 Stronger growth rates amongst smaller companies as ESG strategies mature and can better support linkages to executive incentives.

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US MARKET ILLUSTRATES DIFFERENCES BY COMPANY SIZE

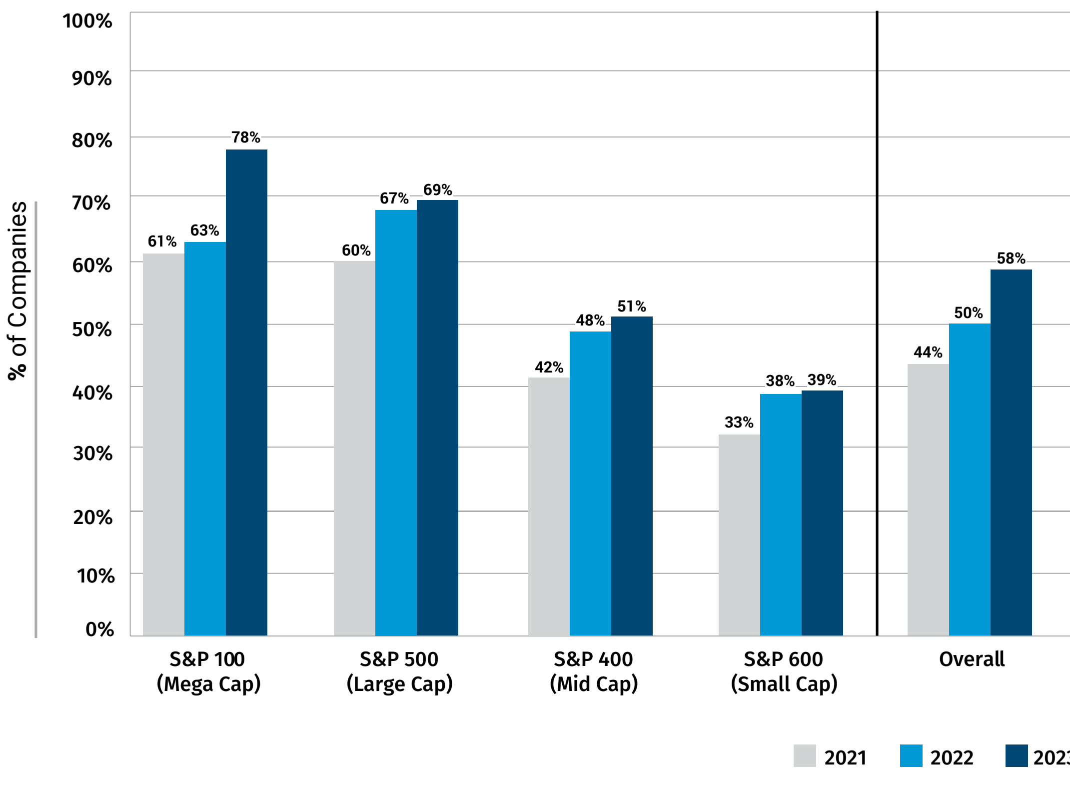
In the United States, 78% of S&P 100 (mega cap) companies now use an ESG incentive measure, which represents a significant jump in one year as many companies worked to incorporate ESG measures into their plans in the face of mounting pressure from investors and other stakeholders in recent years. Taking a broader look at the S&P 1500 index, there is variation by company size. The prevalence of ESG measures tends to drop as we go down to large cap, mid cap, and small companies with prevalence of 69%, 51%, and 39% respectively. The reasons for the drop in ESG metric usage in relation company size include:

External Pressures: Smaller companies tend to face less pressure from investors and other stakeholders (e.g., activist shareholders, proxy advisors) to address ESG concerns, such as developing climate-based targets. In fact, some of the policies around emissions targets or DEI by the largest institutional investors specifically focus on the larger companies, such as BlackRock's policy on TCFD disclosures for S&P 500 companies or the Climate Action 100+ initiatives which focus on the largest global emitters

Internal Resources: Smaller companies tend to have fewer resources to devote to ESG efforts, such as hiring a Chief Sustainability Officer; and some of the smallest companies like those that have recently started trading publicly are simply focusing on viability and turning a profit

Time/Maturity: All companies need time to invest in ESG-related strategies, policies, governance mechanisms, data tracking, and goal-setting (among other steps) before they can begin to consider incorporating ESG measures into compensation programs. A certain level of company maturity is thus required before a company, its management, and its board feel equipped to tie compensation to ESG goals. For this reason, we see some of the largest companies with a long history of investing in their ESG strategies being the first movers in incorporating ESG incentives

Prevalence of ESG Incentive Measures Among U.S. Company by Size



ESG COMPENSATION POLICIES AMONG SELECT GLOBAL INVESTORS WITH PUBLISHED ESG COMPENSATION POLICIES

The voting and/or stewardship policies among large global investors around ESG incentives remains largely unchanged from last year. While many investors do not explicitly discuss ESG incentives in their policies, they may consider them as part of their standard review processes. Investors with published policies on ESG incentives generally fall within two buckets – (1) those that do not require ESG measures, but set certain expectations if used; and (2) those that actively expect their portfolio companies to adopt ESG measures (see below). Key takeaways from both of these approaches include:

- Not all investors have explicit policies on ESG measures
- The largest investors have the same expectations for ESG measures as they do for traditional financial measures
- ESG measures are generally expected to be: tied to long-term strategy, quantifiable and objective (including sometimes expected to have third party verification), and set with rigorous targets
- Investors with explicit ESG metric expectations most often apply those to companies exposed to climate risks, typically expecting companies to use environmental measures tied to climate targets

POLICY DOES NOT REQUIRE ESG	POLICY REQUIRES/EXPECTS ESG
Allianz	AllianceBernstein
BlackRock	Amundi
State Street	Federated Hermes
T. Rowe Price	Legal & General
Vanguard	Northern Trust
	UBS Group

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SELECT

Companies continue to support climate and employee measures in incentive plans

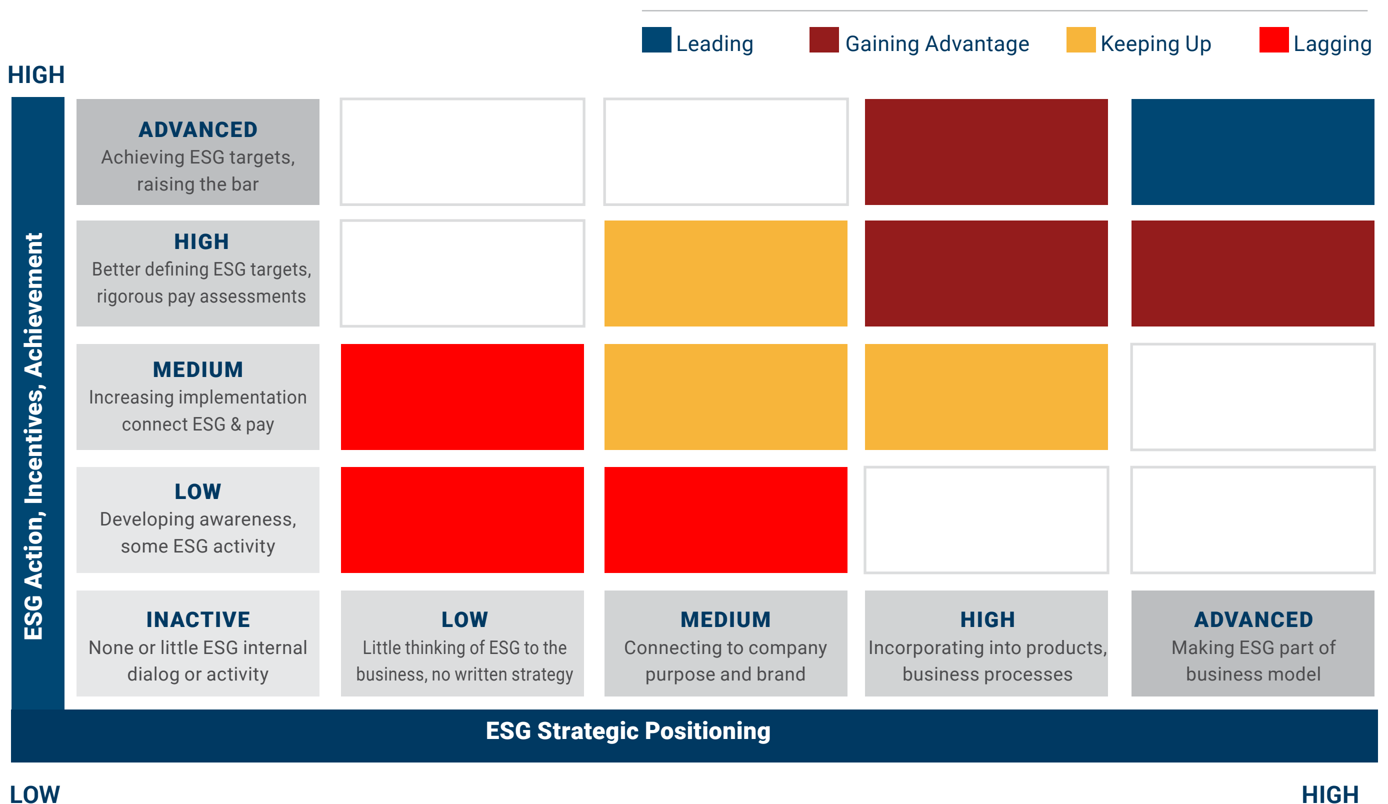
CONTEXT

The range of ESG measures being pursued by companies today is wide. Many companies had initially started to incorporate ESG into performance scorecards. This often involved less precise qualitative measures. As companies have continued to refine and develop their ESG strategies, we are starting to see a move toward better prioritized, defined, and measurable indicators. Prioritization is often guided by what is most material to the business in terms of value creation or risk mitigation over the long-term. Measures so selected will have the advantage of being more business relevant but also carry the risk of not satisfying all stakeholders.

Some stakeholders see a more focused and targeted ESG approach as critical. This may result in greater alignment of ESG measures by industry, thus allowing better comparability. At the same time, it can also reduce the leeway for companies to identify ESG issues that differentiate them from the market and reflect their specific ESG context.

Our experience across our different markets shows that companies go through various phases of maturity as they embark on the ESG journey. As illustrated below, the combination of an organization's ESG maturity and the strategic relevance of the measures they choose correlate to the extent to which they link their incentive plans to the ESG efforts. Even when in a relatively mature stage, an organization may not necessarily be making a material link of ESG performance and executive pay. On the other hand, a company may already be incorporating the incentive plan in a meaningful way while still not being at the highest maturity level.

Understanding the ESG Maturity/Strategic Relevance Framework



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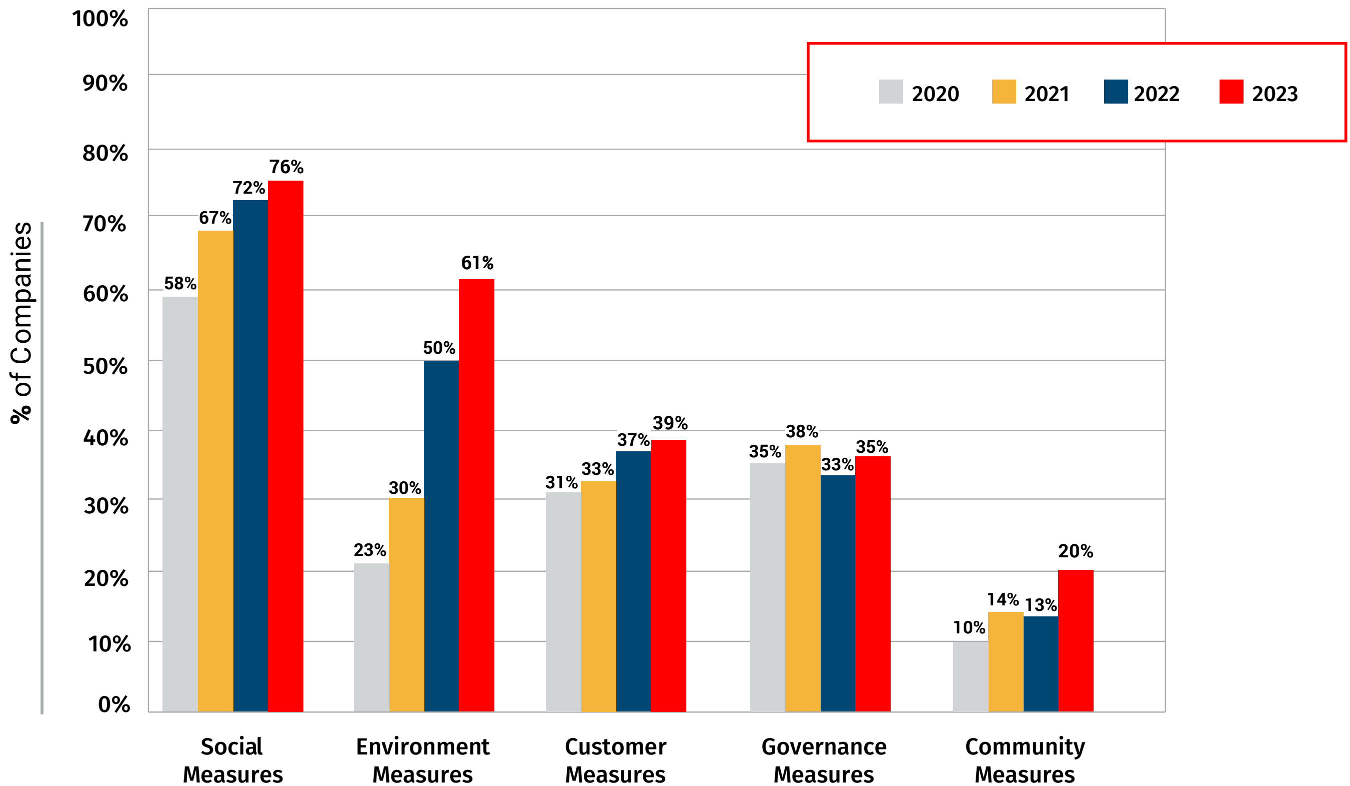
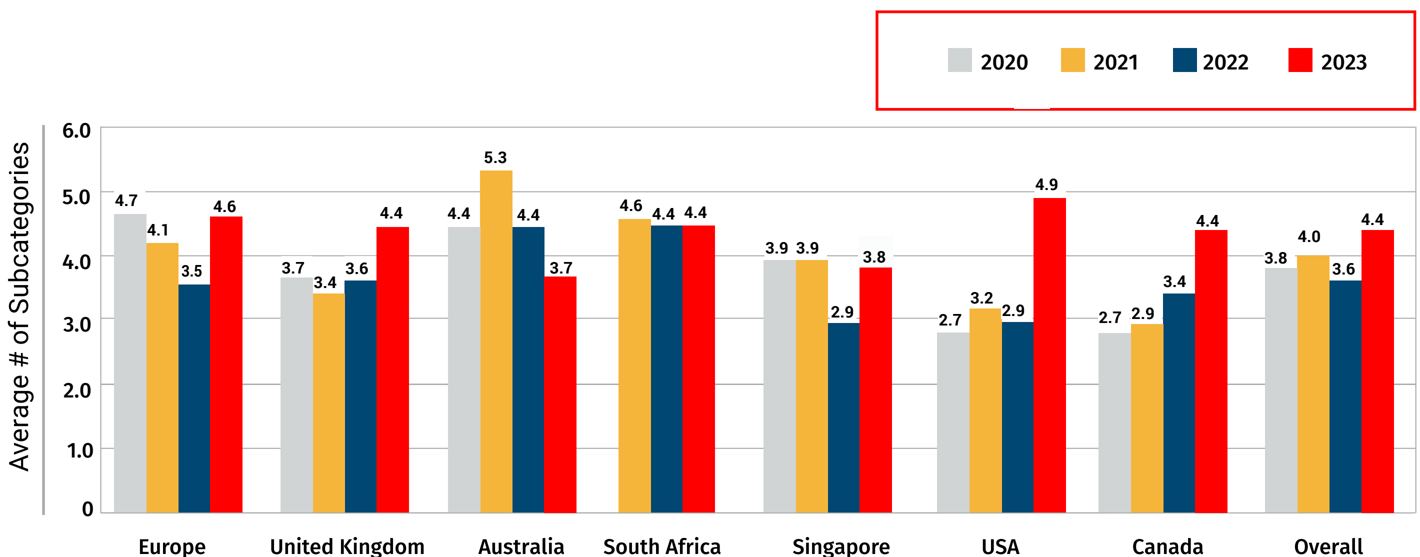
Prevalence of ESG Incentive Measures by Type of Measure



Average Number of ESG Subcategories Used in Incentive Plans Among Companies Using ESG Measures



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CURRENT STATE

- Environmental measures made the most significant gains in prevalence (+ 11pp) with over 60% of companies now using environmental measures
- Social measures continue to be the most prevalent type of stakeholder measure used in incentives (+ 4pp) from 72% to 76%
- Customer and governance measures are used by approximately one-third of companies, but have gained little in prominence
- Community related measures increased in prevalence but are still the least commonly used measure
- Companies are adopting an increasing number of different ESG measures with the most significant increases in Singapore, U.S. and Canada which may satisfy competing stakeholder interests but may make the incentives too complex, as well as more likely to score an "average" or "at target" outcome with little variation across ESG measures.

PREDICTIONS

#1 Environmental and social concerns will remain of paramount importance to society, regulators, and certain investors and the use of environmental and social measures will continue to increase

#2 Other ESG measures may not gain much traction given the materiality of environmental and social measures and the need to limit the number of measures in the incentive plan to provide focus

SELECT

North American and South African companies have increasingly adopted environmental measures, particularly GHG emissions

CONTEXT

Companies continue to focus on climate, perhaps influenced by the growing number of extreme weather events and the increasing stakeholder focus on these issues. These events are making the long-term impacts of CO^2 emissions more tangible, motivating companies to accelerate their decarbonization efforts. Companies are also refining their environment-related ambitions such as by setting earlier dates to achieve net zero or otherwise setting more aggressive environmental targets to be achieved by executives.

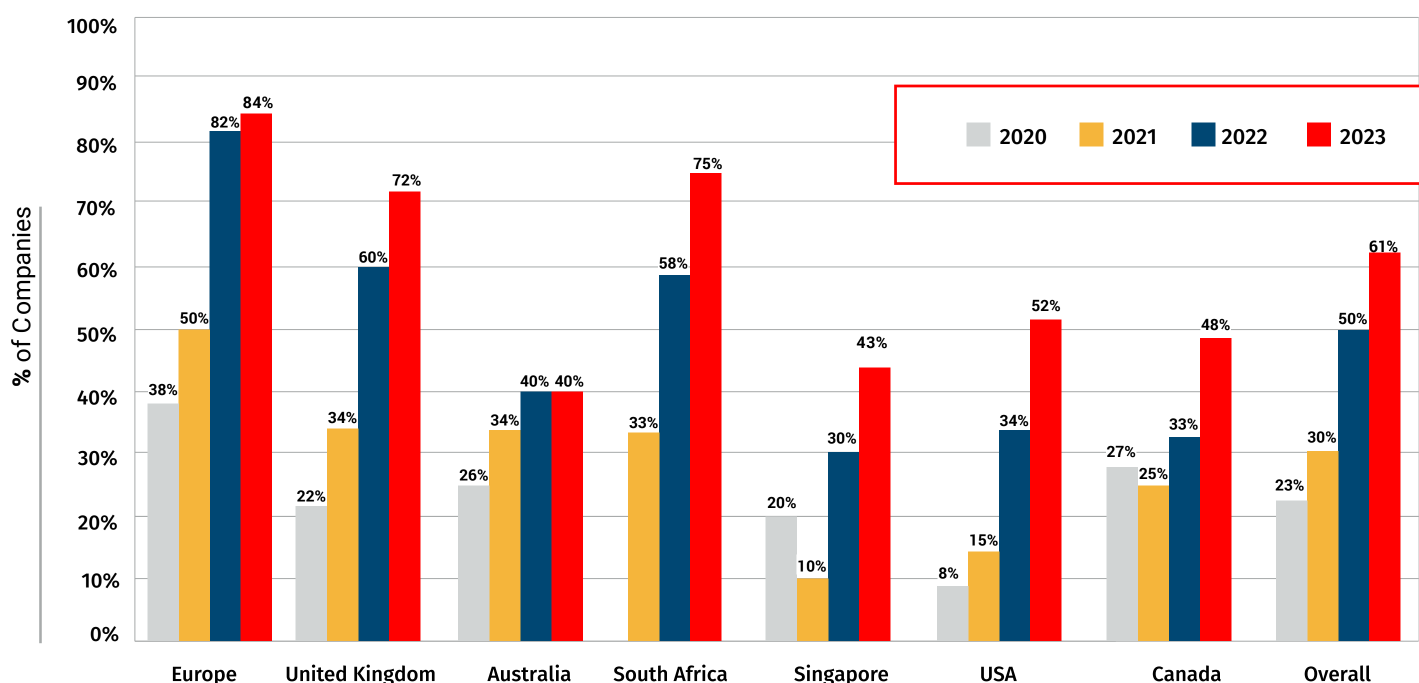
Favorable governmental policies and the geopolitical risks associated with oil & gas are also accelerating the move to renewable energy. However, companies are still facing challenges in managing this transition given that the returns from renewable energy tend to be lower over the short-term than those of oil & gas, likely requiring significant government investment and support.

Companies are also refining their emission measurement approaches with more evidence of measuring of and reporting on Scope 1 and 2 GHG emissions. Scope 3 is still less common, and prevalence varies by sector, likely related to the challenges in defining and measuring those emissions that occur through the entire value chain, such as the risk of double counting, the difficulty in influencing them, and access to data. This makes it more difficult to use Scope 3 to set performance targets and connect to pay. We see a relationship between the prevalence of public targets and the incorporation of emissions within the incentive structure.

CURRENT STATE

- The use of environmental measures in incentives has increased to 61% globally (+11 pp) with significant increases made across the various regions
- Companies in most countries have increased their adoption of environmental measures in 2023 while Europe and Australia remain relatively flat

Prevalence of Environmental Measures by Region



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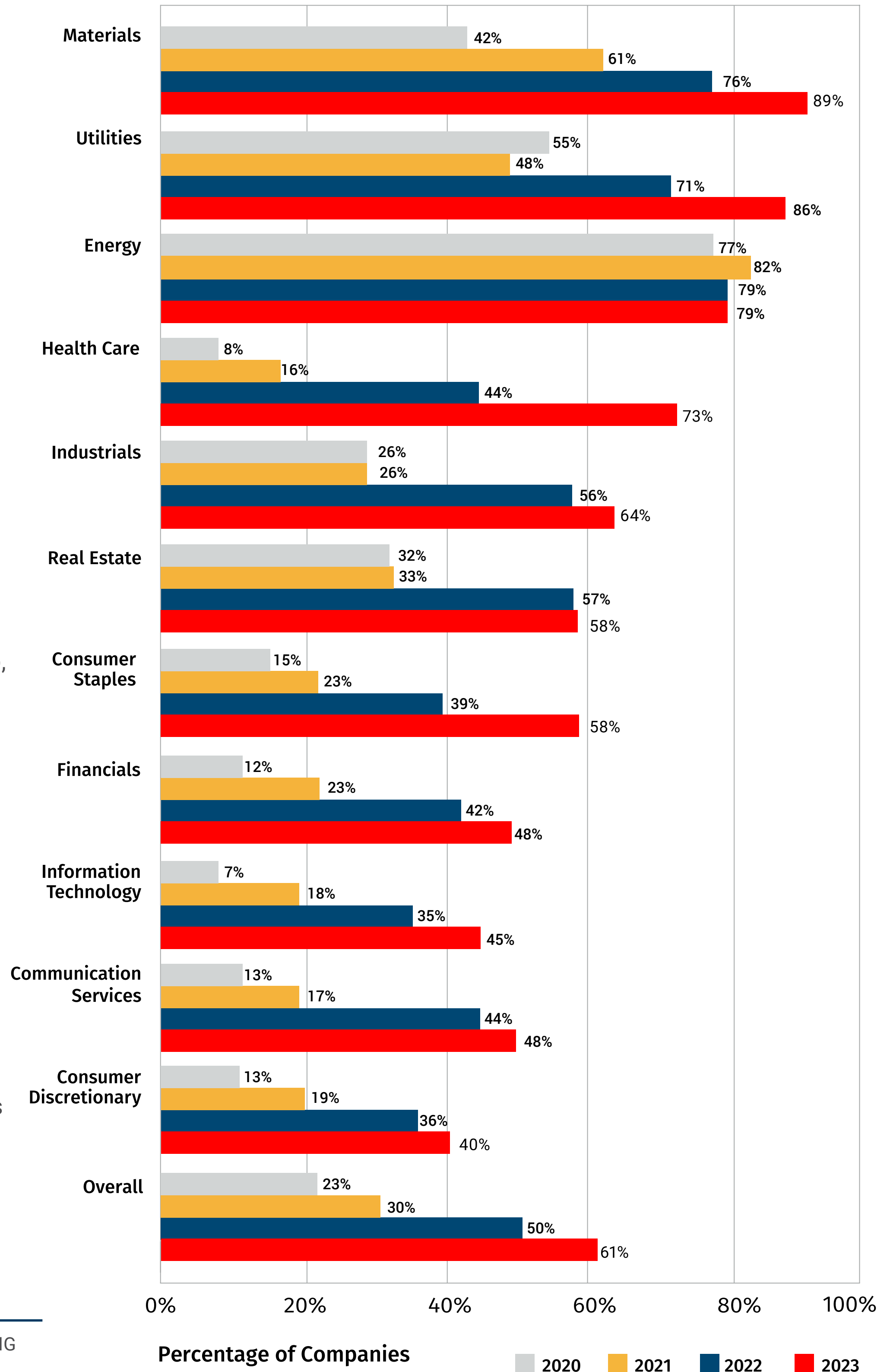
SELECT

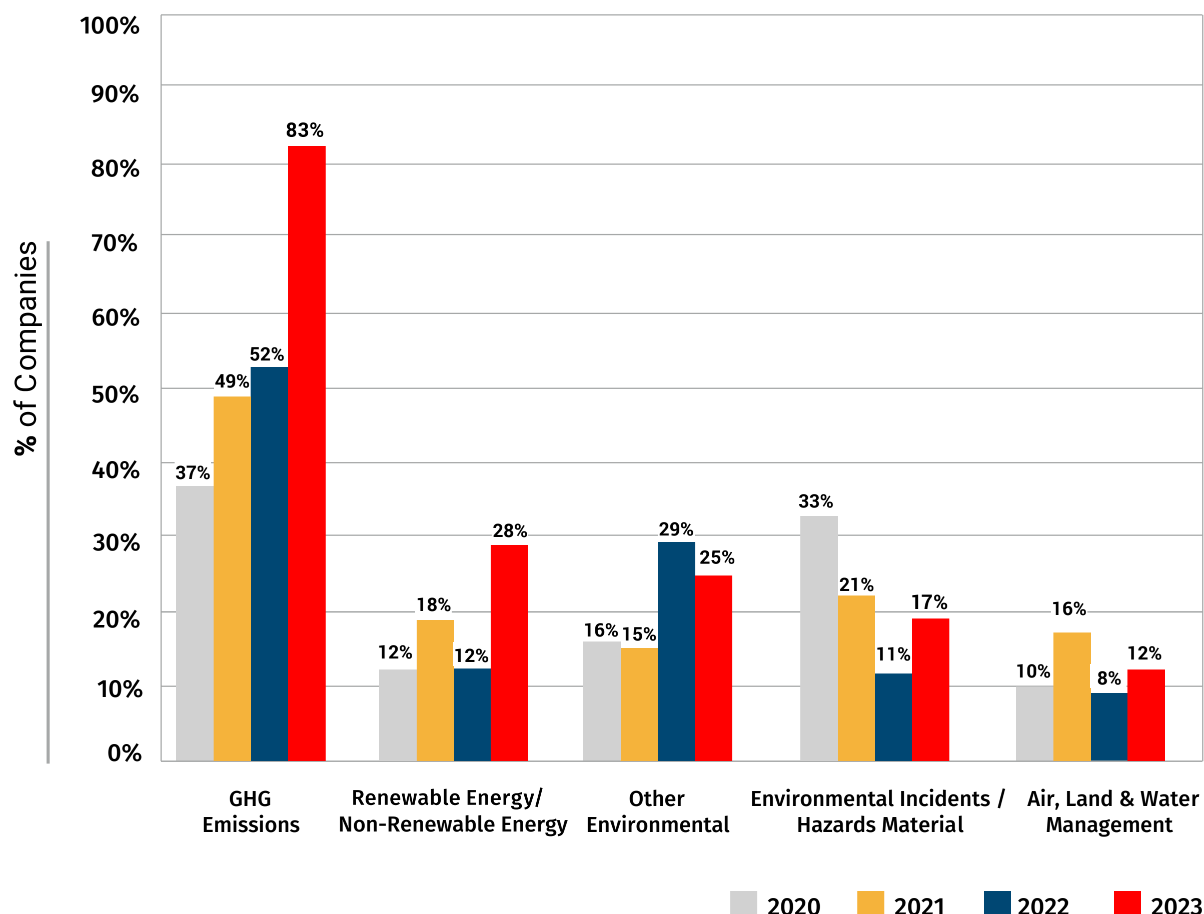
CURRENT STATE

- The use of environmental measures has increased across all sectors, especially in the Health Care sector
- The adoption of environmental measures remained flat in the Energy sector, suggesting that those that have not yet adopted, are less likely to adopt an environmental measure
- The relatively modest use of environmental measures in the Financials sector remains a surprise given the influence that both banking and insurance companies can have on their customers to support environmental progress, the impact it can have on costs and margins (especially in insurance), and the intensity of activists, especially against bank financial support for carbon emitters
- GHG emissions are by far the most common type of environmental measure increasing by 31 percentage points year-over-year. This big increase coincides with increases in companies setting emission reduction targets and disclosing them publicly (63% of S&P 500 and STOXX Europe 600 companies have publicly disclosed Scope 1 & 2 emissions reduction targets, typically by 2030)[2]
- Other environmental measures have generally also increased year-over-year but remain minority practices



[2] ISS Corporate Solutions Report on GHG Reduction Targets (September 2023)

Prevalence of Environmental Measures by Type Among Companies Using Environmental Measures



PREDICTIONS

#1 Continue to see an emphasis on GHG emissions as the primary environmental measure with a stronger focus on how it is defined (Scope 1, 2, 3) and how meaningful progress is being made relative to the long-term commitments being made

#2 Some companies may look beyond GHG emissions as their environmental strategies mature (e.g., nature-related risks, biodiversity) but prevalence may remain low until these issues are seen as more important than GHG emissions

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SELECT

Examples of Environmental Metrics

Waste Connections (US/Canada) Added new LTIP targets for the absolute reduction of Scope 1 and Scope 2 emissions and reducing emission intensity measured as a percentage of revenue. These are in addition to other sustainability objectives in the LTIP.

Carnival (US)
Added a specific GHG intensity reduction target in 2022 (10% of the STIP).

Delivery Hero (Germany)
Adopted a new STIP that was 100% based on ESG measures. The environmental measure (weighted 1/3rd of the STIP) is based on the sale of sustainable packaging units.

"Boards will need to continually improve and build their skills to deal with the increased sophistication of all aspects of ESG including strategic oversight, risk and governance."

-Yannick Hausmann, Chairman of the Board, HSBC Private Banking, Switzerland

The adoption rates of DEI measures are starting to slow down as companies look to other employee-related measures

CONTEXT

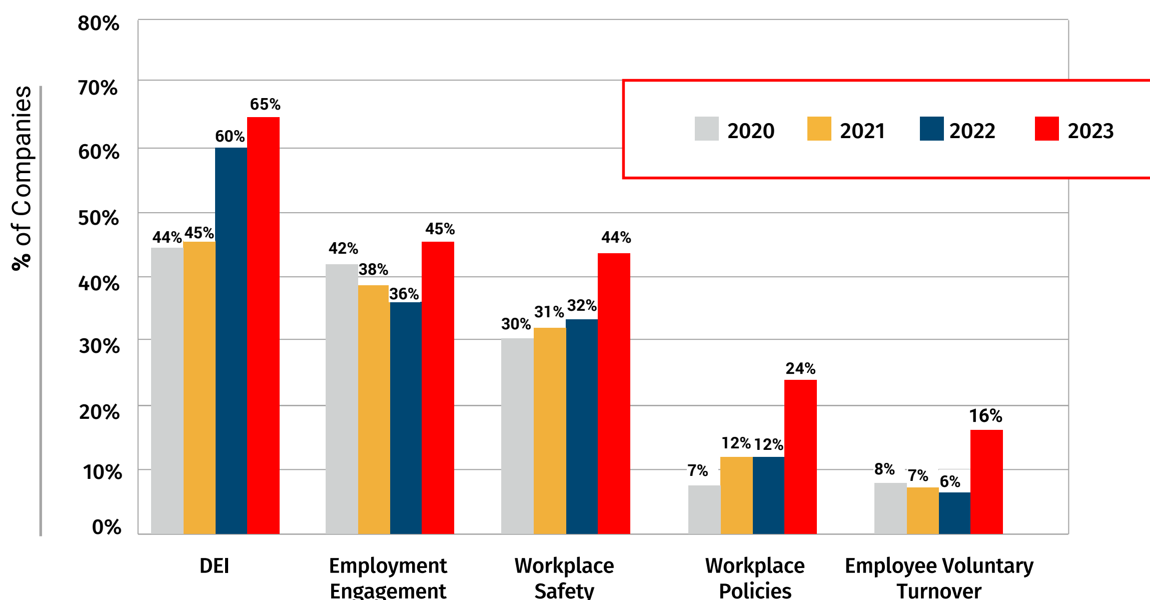
Our study this year shows further growth in the use by companies of diversity as part of the "S" of ESG. But how diversity will continue to be pursued may be coming under some tension.

Diversity means different things depending on the local legal and cultural conditions. There appears to be little dispute across regions that diversity of thinking and experience can benefit a company, whether at the Board, executive, or workforce level. Better representation of women on boards and senior management also receives strong support in most parts of the world as does non-discrimination based on racial, ethnic, or religious grounds. Where major differences appear to exist is in on the "how" of promoting diversity, particularly when done in a way that may be perceived to bump up against other important goals such as equality of treatment. While not the only demonstration of these tensions, the recent US Supreme Court case on racial preferences in university admissions might have legal and even broader implications for corporate diversity efforts. Companies committed to diversity will have to carefully navigate between being responsive to stakeholder expectations on diversity and not acting to contrary law.

CURRENT STATE

- Close to 70% of companies using social metrics have adopted diversity, equity, and inclusion (DEI) measures (+ 5 pp)
- After a few years of little change, the other social measures have also seen an increase in use although they still remain minority practices

Prevalence of Social Measures by Type Among Companies Using Social Measures



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SELECT

PREDICTIONS

#1 Evolution in the types of employee measures to provide greater balance and to address key priorities through the employee life cycle

#2 The types of DEI measures may evolve given recent legal decisions that may make the use of representation targets more challenging

Examples of DEI Metrics

Hanes Brands (US)
Adopted a DEI modifier in the STIP. The modifier can adjust the STI payouts up or down by 5% depending on performance against workforce representation targets.

Fortis (Canada)
After adding DEI to the STIP in 2022 (weighted at 10%), they added a DEI modifier based on executive representation targets (+/-5%) to the 2023 Performance Share Units as part of the LTIP.

Dow (US)
Disclosed changes to its STI plan for 2023, notably changing the name of the ESG component of its plan from “ESG Metrics” to “Ambition Metrics”. This includes Global Representation of Women and U.S. Ethnic Minority Representation

INCORPORATE

ESG incentives are increasingly being incorporated into long-term incentives

CONTEXT

Our earlier studies have shown that as companies add non-financial measures to their incentives, it is typically far more in the short-term incentive (STI) than in the long-term incentive (LTI).

This year we see a continuing increase in the companies including ESG in the LTI.

The reason for the continuing preference for the STI might be related to the significant time and other resources required to design and implement long-term ESG metrics. Some would argue that the pace of change in measurement and technologies are so rapid that it is easier to incorporate into annual rather than longer term measures. Furthermore, long-term metrics could potentially adversely impact short-term financial performance while the benefits may take time to realize. The STI can also support interim progress towards more meaningful ESG outcomes.

For an LTI, companies tend to look for measures reflecting long-term priorities where long-term targets can be reliably set. Many LTI have overlapping multi-year performance periods which can introduce added complexities if the measures and/or targets change regularly. Despite the challenges, putting ESG metrics in the LTI – or as a separate ESG LTI with discrete and/or longer measurement periods - can be a sensible way to provide meaningful incentives for executives to take a longer-term view and work toward ESG progress over the next 3 to 5 years. It reinforces the line of sight that executives, who usually participate in LTIP, can have relative to driving meaningful change. Lastly, it permits executives to pursue longer term ESG strategies requiring capital expenditure which may not have as early an NPV break even point as other alternatives, and subsequently lower shorter term TSR outcomes.

CURRENT STATE

- More than one-third (34%) of global companies with ESG measures now use those measures in their long-term incentive plans (+6 pp)
- South Africa, Europe, and the U.K. have the highest prevalence of ESG measures in their LTI plans
- U.K. and Canada saw the largest year-over-year increases (+21 pp and +13 pp, respectively)
- Companies in countries such as the U.S. and Australia have demonstrated a slower uptake in the use of ESG measures in their LTI plans

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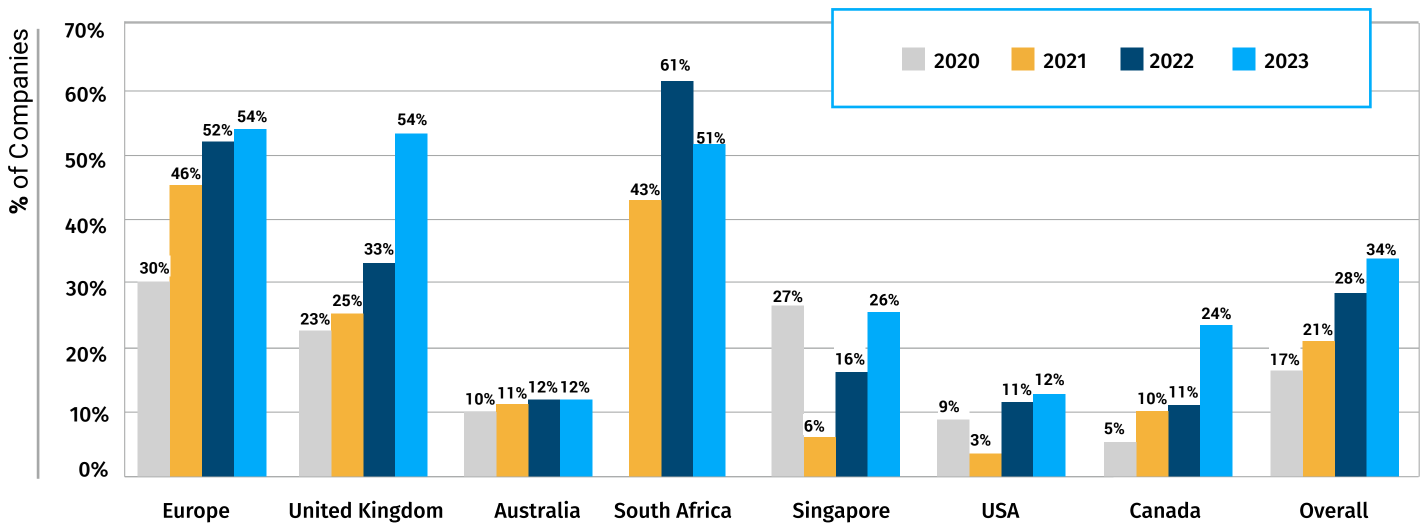
INCORPORATE

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



PREDICTIONS

#1 Continued inclusion in the LTIP as multi-year targets get established, particularly for GHG emissions. The introduction of IFRS S1 and INFRS S2 sustainability reporting standards across most countries will at least sustain current levels, and may facilitate greater adoption within LTIs

#2 Companies may decide to remove some or all ESG measures from the STIP if incorporated into the LTIP to manage duplication and provide greater focus

Examples of LTI ESG Metrics

Suncor (Canada)
Climate Performance Share Units (5% of LTIP) based on GHG portfolio health, GHG capital allocation and reductions by 2025.

Safran (French)
Includes CSR and sustainable development objectives to the LTIP (weighted at 20%) including environmental and climate issues, gender equality (proportion of women senior executives) and employee safety.

Anglo American (UK)
The 2022 LTIP includes 20% on ESG measures including freshwater withdrawals (8%), renewable energy (6%) and social responsibility (6%).

IS IT TIME FOR HYPER LONG-TERM INCENTIVES?

Given the long-term nature of many ESG objectives, e.g., 30% reduction in GHG emissions by 2030 or 2035, could a separate LTIP tailored to that period provide true long-term alignment to these stated objectives? The path to these objectives may not be linear and may take many years to make meaningful progress. A special eight or 10-year LTIP that is carved out or in addition to the regular LTIP can create a more direct connection for plan participants. The period might be too long for many executives with shorter time horizons, but with the right termination provisions, executives could still be held accountable and rewarded even if they leave on good terms prior to the end of the period.

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INCORPORATE

Companies are not adopting quantitative-only ESG measures

CONTEXT

There continues to be an evolution in the emphasis and rigor 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.

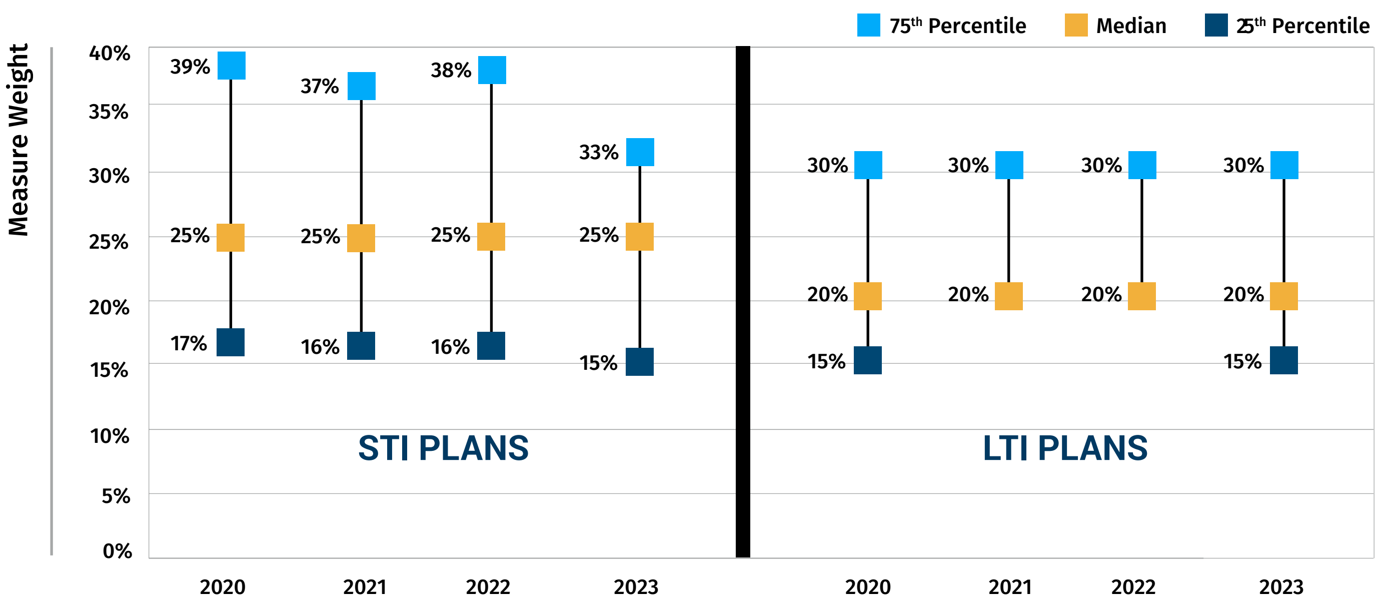
Investor pressure has forced more companies to migrate from only qualitative or “soft” measures to more quantitative goals. For example, a company that used disclosure of GHG emissions as an activity- based goal in a prior year may be switching to a quantitative GHG emissions reduction target which can be tracked from one year to the next and so statistically disclosed.

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

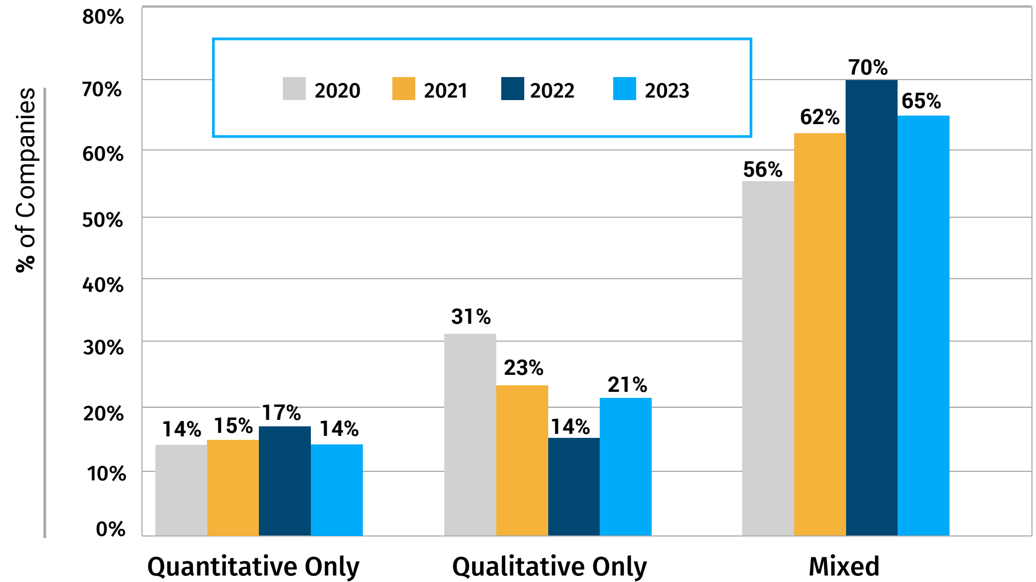
CURRENT STATE

- When used, ESG measures in aggregate continue to be weighted about 25% in short-term and 20% in long-term incentive plans
- Only about 14% of companies use strictly quantitative ESG measures in their incentive plans with the rest using qualitative or a mix of measures
- Companies adopt ESG measures either as weighted individual metrics or as a scorecard of multiple metrics. Practice varies around the world with North American companies more likely to adopt a scorecard

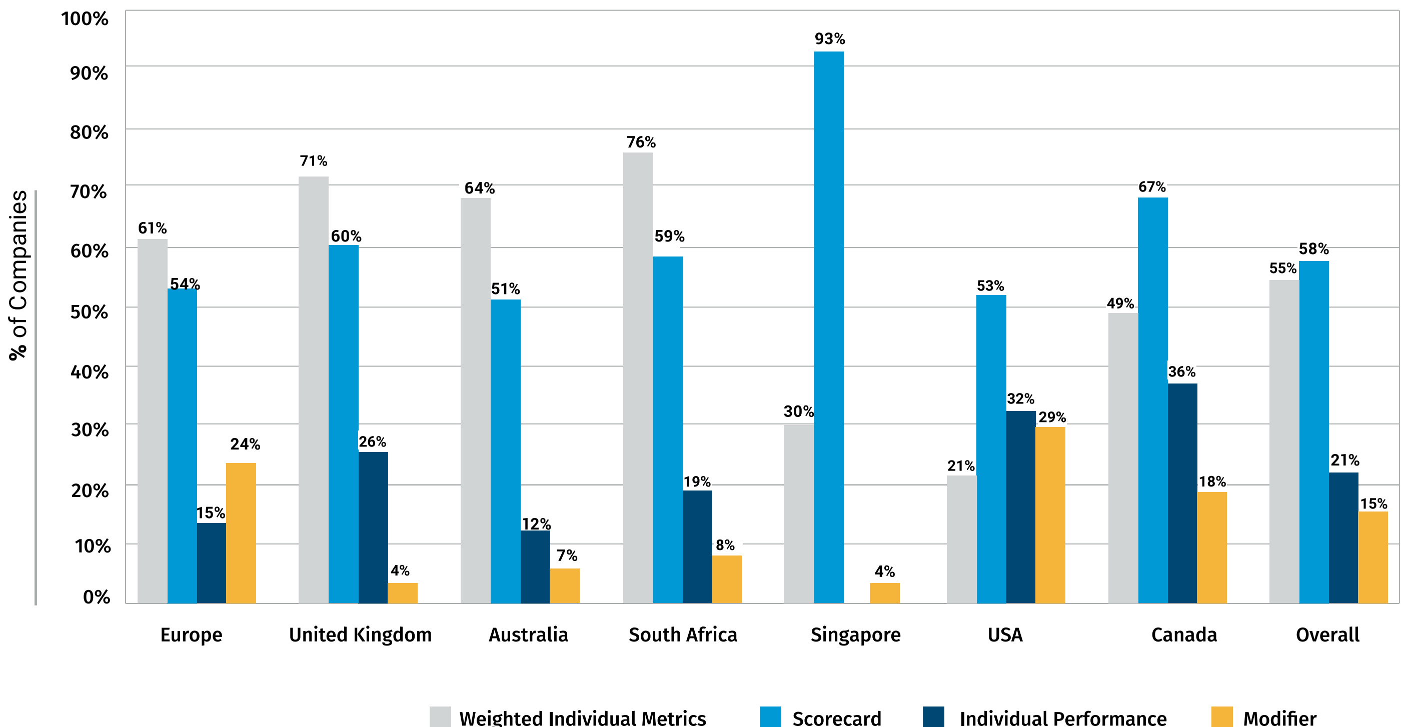
Weighting of ESG Measures in Incentive Plans



Prevalence of Quantitative vs. Qualitative Measures Among Companies Using ESG Measures



ESG Measure Implementation Type Among Companies Using ESG Measures



PREDICTIONS

#1 Continued weighting of about 20-25% of either the STIP or the LTIP

#2 Increased quantification of measures with specific measurable goals disclosed

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GOVERN

ESG incentive measures and targets tightened up, and payouts less assured

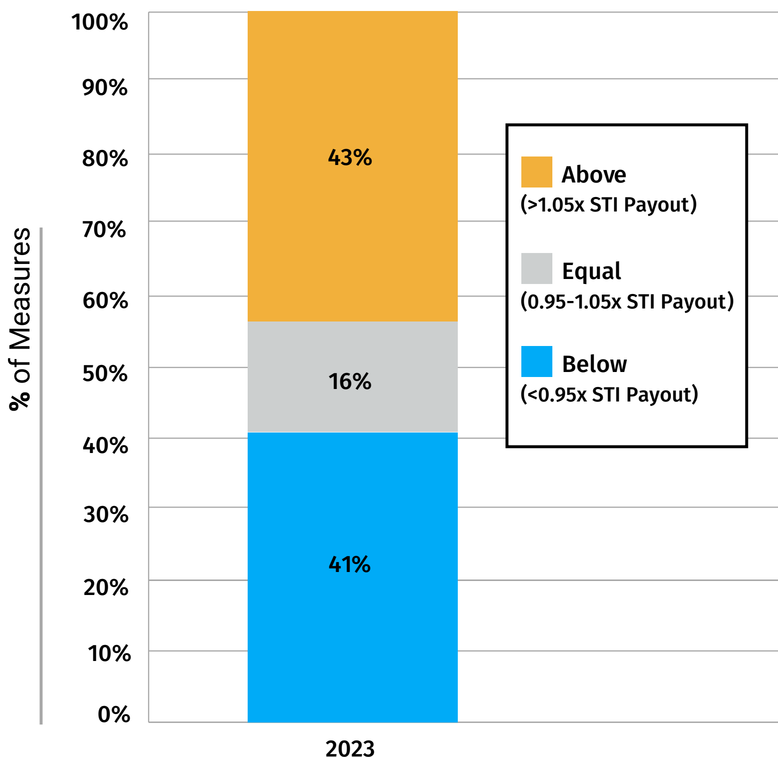
CONTEXT

There continues to be criticisms that ESG targets may be too easy to reach and may be used to pad executive incentive payouts relative to the traditional financial performance measures. As ESG strategies continue to mature in the years ahead, we will expect greater consistency in performance definitions and the ability to better assess performance given historical trends. While not directly derivable from the data of this year, our experience with clients suggest that companies are starting to take a more rigorous approach to setting ESG performance targets and the ranges around targets, borrowing from the development over time of more precision in financial performance measurement. We are now already seeing more reporting on ESG targets and comparisons relative to peers.

"The world has moved from a time where ESG was only briefly mentioned in company reports, to when companies created flashy ESG reports. The future lies in having auditable ESG figures which will just become part of how one does business and reports on it".

-Jack Clemons, member of several European boards.

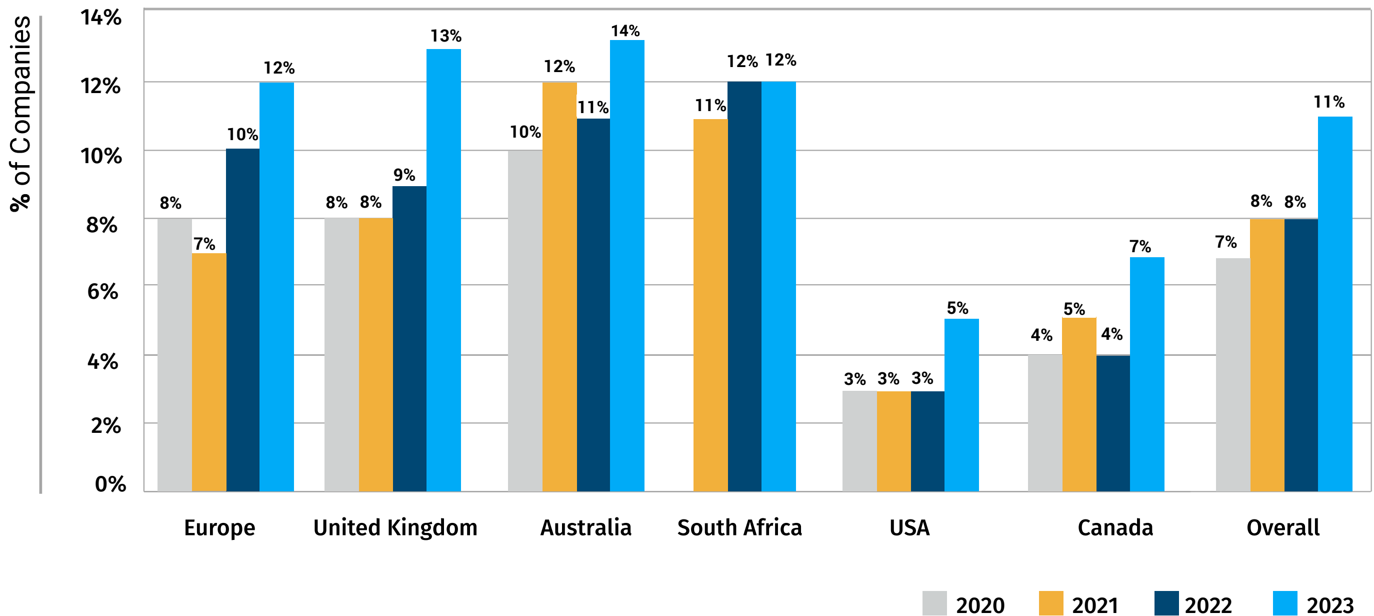
Payouts of ESG Measures Relative to Total Payouts for Corresponding STI Plan



CURRENT STATE

- Payouts on ESG incentive measures were generally split between paying out above and below the corresponding STI award; only a small proportion (16%) of measures paid out roughly equal to the overall STI award in 2023
- The overall weighting of ESG measures as a share of total compensation, on average, has continued to increase and vary by region (from 5% in the U.S. to 13/14% in the U.K. and Australia)

Overall Mix of ESG Measures as a Percentage of CEO Total Compensation Among Companies with Weighted ESG Measures



PREDICTIONS

#1 Continued focus on target setting and refinement of the performance objectives to warrant their results

#2 May see greater range of ESG-related payouts above/below the rest of the incentive as outcomes differ from the other incentive objectives

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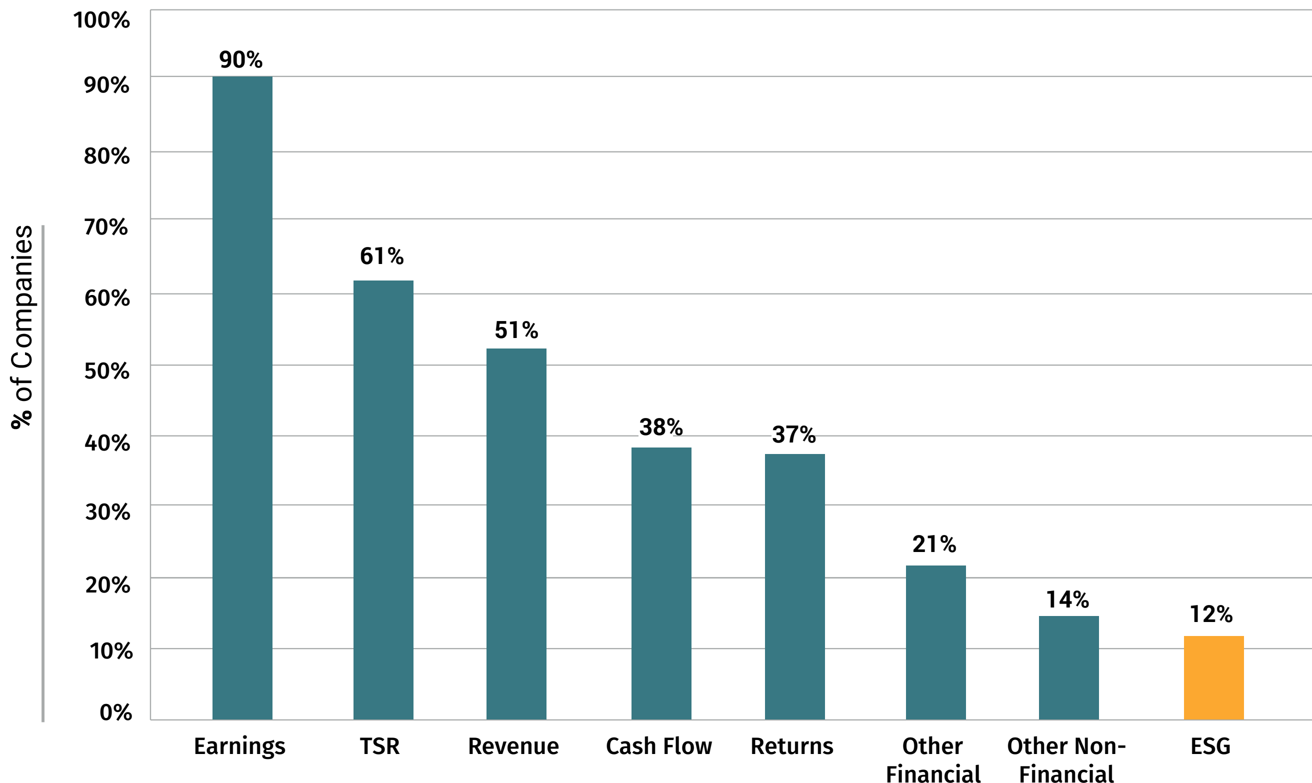
GOVERN

US Pay vs. Performance (PvP) Disclosures Underscore Relatively Low Weightings on ESG Metrics

Starting in 2023 all US publicly-traded companies have been required to disclose a list of the three to seven "most important" metrics that link to executive compensation outcomes as part of the new PvP disclosure requirements. Companies for the most part list the measures used in their incentive compensation plans. As such, 90% of companies list an earnings measure as most important, 61% list TSR, and 51% list revenue, as these measures are common in short-term and long-term incentive metrics.

Interestingly however – while nearly 70% of S&P 500 companies use ESG measures in their incentive plans, only 12% of companies listed an ESG measure as "most important." This apparent contradiction is likely due to the lower weight that companies place on ESG measures compared to financial measures. And when asked to identify the "most important" metrics, many companies selected those with the highest weight in the plans. Additionally, the SEC's rule used the language "most important financial metrics" while still allowing companies to list non-financial measures, which likely tilted many companies toward listing only financial measures.

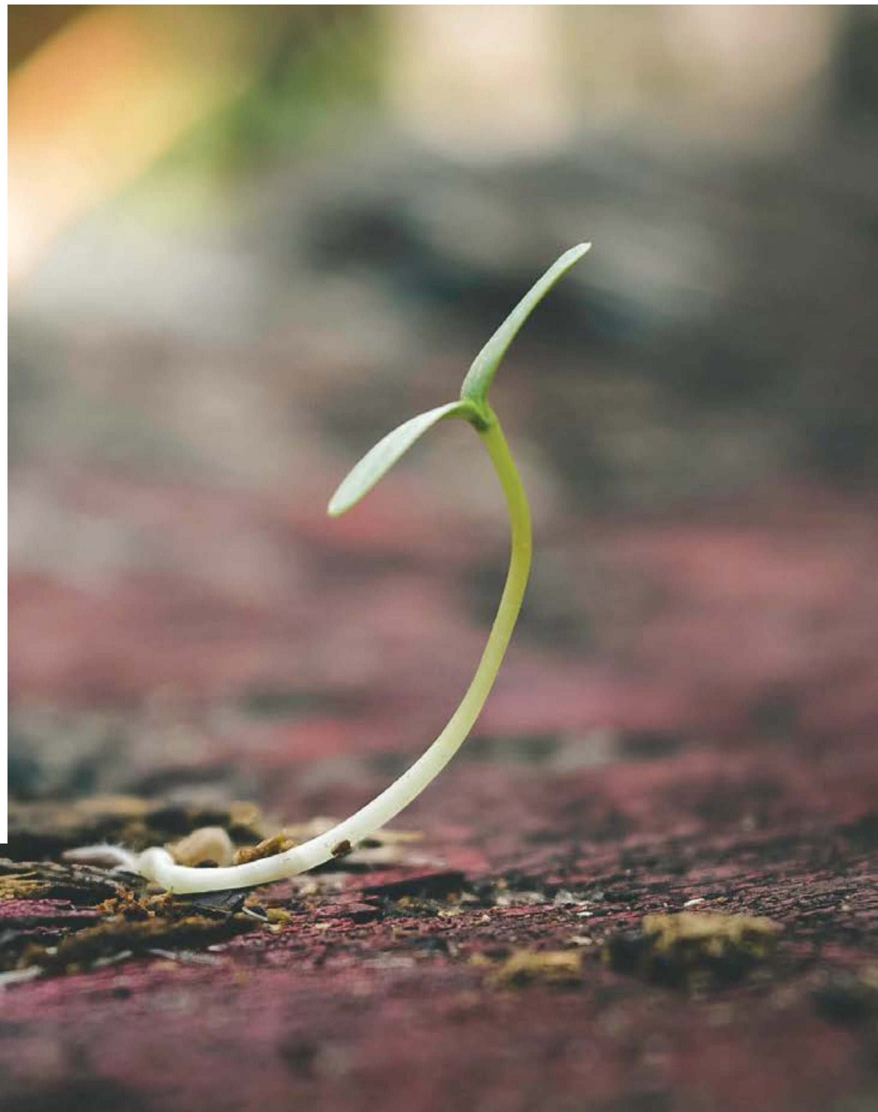
Most Important Performance Measures Cited by US Companies in PvP Disclosures



Going Back to Incentive Design Basics

As investors look to companies to include ESG-based incentives on a similar basis as other financial measures and as companies build a better understanding of their ESG priorities, targets and baseline levels of performance, it might be time to go back to incentive design basics, including:

- Focus on fewer measures that are material to the business
- Follow strategy decisions (not lead) with clarity on what ESG incentives can do and what not
- Review target-setting and level of ambition for ESG measures
- Create the right balance of measures to manage unintended outcomes
- Drive change / improvements (avoid argument that ESG measures overpay for insufficient progress or for "doing your daily job")
- Identify quantifiable and outcome-based measures with sufficient room for discretion by Board of Directors to appropriately reflect intended outcome and actual performance (avoid "hitting the target but missing the point")
- Align with time horizon to effect change (or at least break down long-term time horizon such as 2050 into shorter cycles with ambitious targets for each)
- Confirm governance processes to verify, compare, and oversee outcomes



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Considerations for Directors

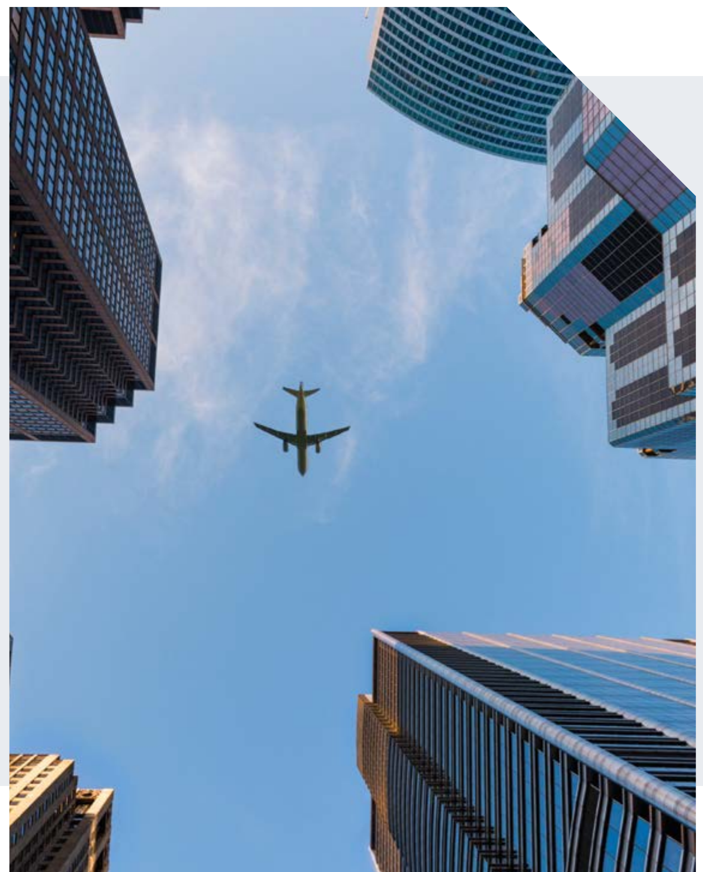
Boards will need to adopt different approaches to ESG-based incentives depending on the company's business model and the degree of ESG maturity. For some companies, this will involve fundamental decisions on whether to adopt ESG measures at all given the tensions that we are seeing within various jurisdictions and evolving investor preferences. Other companies will want to review and refine their measures to put a greater focus on their specific ESG priority areas, which are increasingly being defined as GHG emissions and employees, but which may depend on their company's internal assessment. In some cases, companies may be able to make their measures even more meaningful by creating quantitative targets and putting the measures within the LTIP. Finally, the more mature companies on the ESG spectrum can focus on setting meaningful and rigorous targets that are seen as credible and important to their stakeholders.

At the same time, the broader ESG landscape continues to change. Investor preferences are shifting. Global standards are being developed. Stakeholder expectations are becoming clearer. ESG is increasingly embedded within the underlying business strategy.

The board needs to continually review and monitor their approach to the use of ESG incentives. They need to push management to make meaningful progress on their ESG strategies so that the right measures can be adopted, where it makes sense. They need to monitor progress and ensure alignment throughout the organization and across stakeholders.

RECAP

- Continued adoption of ESG measures within specific sectors and regions; among smaller companies prevalence remains lower
- Increased focus on GHG emissions and employee-related measures as the primary ESG-related measures
- More quantification of ESG measures in support of meaningful improvements over time
- Greater use of ESG measures in LTI plans to align with longer time horizons and to increase the emphasis on ESG within total compensation
- Further alignment of ESG measures as global standards evolve allowing for greater comparability and benchmarking amongst peer companies



CONTACT US

We hope this research contributes to the advancement of ESG and stakeholder engagement. We invite your questions and comments. Feel to directly contact any of firms in the GECN Group or write to international@gecn.com

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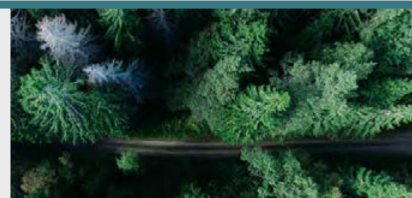

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