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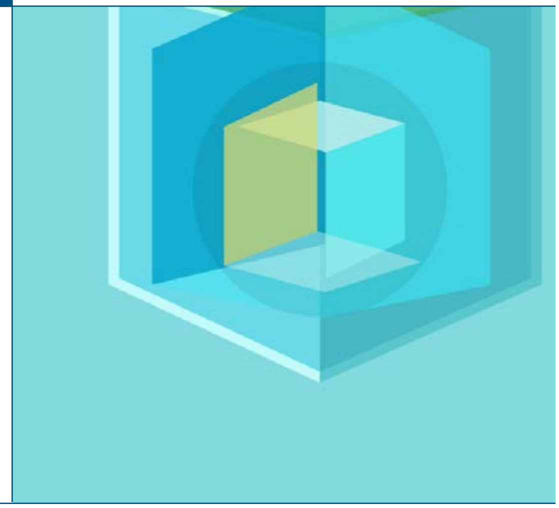

Moving Cautiously on ESG Incentives in Compensation

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Since the Business Roundtable's 2019 call for greater attention to all stakeholders, corporate boards have been elevating environmental, social, and governance issues in their discussions. Last summer's widespread protests over racial injustice put extra attention to diversity, equity, and inclusion (DE&I) issues. Boards have begun the difficult work of determining which ESG goals are especially important for their company, and how to translate those goals into incentives for executive compensation where appropriate.

General Reflections

ESG has not yet become a mainstream issue for executive compensation. But the level of inquiry from our clients (predominately corporate boards) has increased dramatically. Those clients say they in turn are getting questions from investors. Often these are about ESG-oriented initiatives generally, but they frequently circle back to executive compensation.

One financial services client, for example, met with large institutional investors recently and spent almost a full hour on ESG. A consumer products client had a similar experience. The investors asked some pointed questions:

- What are your company's top three ESG considerations?
- What engagement have you done with stakeholders to determine these?
- How do you translate your views on sustainability into strategy and risk management?
- What are your KPIs on these ESG issues?
- What is your process for board oversight and governance on ESG issues?
- Do you use ESG in your incentive plans?

State Street met with another of our clients specifically on human capital management (HCM), which is a major ESG area. These questions came up:

- How does your HCM connect to your business strategy?
- How are you promoting social equity in your workforce composition and compensation?
- Does your organizational culture give employees a voice?
- How are you promoting diversity and inclusion in your management ranks?
- What is the board doing to oversee management in these areas?

Besides State Street, the New York City Comptroller's office and activists such as Arjuna Capital have pushed for transparency on DE&I matters. Beyond HCM, high-profile investors such as BlackRock have made a priority of addressing climate change. Shareholder proposals in these areas are becoming more prevalent and garnering more support.

Boards are feeling pressure from other stakeholders as well. Customers and employees are expecting the companies they support to lead on ESG issues. Local communities are stepping up their calls for help with education, skill building, and finance. ESG issues are becoming important to the corporate brand, for employees as well as customers.

Based on our conversations with clients, we urge all boards, especially at large companies, to be prepared to answer these questions. Their company's current level of activity is less important than demonstrating that they are aware of these issues and on a journey to raising this level as appropriate.

It's only natural for these discussions to lead to questions about compensation metrics. After all, if progress in ESG has become so important, shouldn't we measure and tie pay to it? And if stakeholder capitalism really is the new approach, shouldn't companies demonstrate their commitment by measuring more than the financials?

So far, however, investors are being prudent in their guidance on ESG. They want to see focus and progress, with measurement and board oversight, but they generally are not insisting on a compensation link. Companies themselves seem to be driving most adoption, some as a way to strengthen their corporate brands, and others after losing a Say on Pay vote or suffering from public troubles.

ESG for Compensation: Move Carefully, but Move

Linking ESG metrics to executive pay is a powerful way to drive change. But compensation is a sensitive instrument, so we urge caution. As with any other new metric, a board should craft it to reflect the company's context and ESG priorities—and to complement the existing pay incentives. The board should also test a metric before including it in compensation, to reveal unintended consequences or the possibility of gaming. Rather than a single decision, new pay metrics involve a journey that begins with elevating certain issues internally and externally.

We believe an ESG metric is worth considering for compensation if management and the board:

- Identify the issue as a strategic priority
- Understand that elevating one ESG issue may send unintended signals about other issues
- Have clarity on an effective strategy and the outcomes that define success
- Are committed to maintaining the metric for an extended time period, with durable goals
- Are willing to set real, stretch goals for driving change, not easily-achieved goals for publicity
- Understand that goals may be missed and is willing to disclose why

The board's commitment is critical—this must not be a short-term publicity exercise. ESG goals almost always require multi-year efforts. There's also a signaling component: while adding the metric to your incentives may send a positive message, taking it away or diluting it later will do the opposite. Moreover, compensation real estate is limited. Each new metric may dampen the push from existing metrics. It is important to prioritize, and then appropriately balance all incentive metrics to the most powerful effect.

Boards should start with just the most relevant issues, rather than address all corners of ESG at once. ESG encompasses many areas, and each industry or sector will have a different set of priorities. Boards need to do the work of assessing a number of worthy goals with

WHAT'S DRIVING ESG IN INCENTIVES?	
Sector-Driven Strategies	• **Energy:** – Shell committed to carbon footprint reductions in the long-term component of its incentive plan, as well as measuring it annually • **Retail & Consumer Goods/Services:** – McDonalds and Starbucks announced goals focused on Human Capital Management – Clorox and Mondelēz are focused on sustainability and recyclability initiatives (e.g., in packaging); Mondelēz also has metrics for DE&I – A global apparel retailer emphasizes sustainable growing and human rights via sustainably sourced cotton – Chipotle branded itself a "clean food company" and recently announced it would base 10% of its annual executive bonus on multiple dimensions of that mission: racial and gender DE&I, sustainable food sourcing, and accelerated disclosure of a new environmental report • **Distribution:** – Companies in this sector could focus on reducing carbon emissions with a more climate–friendly fleet, or working with suppliers for sustainable sourcing, manufacturing, and packaging
The DE&I Imperative	• **Companies want to show their commitment on DE&I, and compensation can be an important signaling device** – Starbucks & Prudential introduced a mechanism to vary the size of LTI performance-based share awards based on their ability to meet DE&I goals related to representation • **Promoting individuals who lead on these issues as well as accelerating their pay trajectories may be more effective than compensation metrics**
Geographic Pressure	• **Many of the pioneers are based in Europe. Boards at European companies will be under greater pressure to adopt ESG incentive metrics and will find more support when they do** – Siemens has a sustainability index weighted 20% in its LTI that includes CO_2 emission reductions, employee training, and NPS
Community Needs	• **A food distributor can perhaps differentiate itself by helping eradicate hunger nearby** • **A bank might help with micro-finance and financial education** • **A technology company might offer training programs (online or working with city/ community colleges) to build competencies in high-demand skills**

the company's specific strategy for customers, employees, or other stakeholders. Where can you make the biggest impact, or where do you have the biggest gaps? Also, what can you measure and control? Are you looking to limit a major risk, or capture a big opportunity?

In terms of who gets involved, often the ESG responsibilities are shared across several committees. Even in boards with an actual ESG committee to drive that agenda, that committee will have to interface frequently with the compensation committee on pay metrics. In assessing progress on the metrics, an ESG committee may also need to talk to the finance, nominating and audit committees. And within management, finding the right measures for a compensation link will likely involve the sustainability group, HR, Finance, Legal, IR and others.

Finally, boards should remember they have multiple tools for driving change in an organization, not just incentive compensation. For example, they can ensure a leader's ability to build an inclusive environment, influence hiring and promotion, and consider broader ESG concerns and ability to execute ESG strategies when they next decide on a CEO. They can also adjust the non-compensation Total Rewards mix to give greater prominence to ESG. Boards also have a role in shaping the organizational culture.

It's a Process

As companies orient to the best way to pay for ESG accomplishments, boards can start with a scorecard approach in their annual incentive program. The scorecard can bring together ESG priority areas and even include some qualitative goals. Results on the scorecard, as determined by board discretion, will account for a small portion of compensation (e.g. 20%). Over time, as the board learns how these incentives work, they can replace the scorecard with hard metrics measuring annual progress towards long-term goals. These goals will likely extend to the long-term incentive (LTI) plan as well since most require multi-year effort. Even if you start with qualitative assessments, it's important to use objective metrics to inform the assessments. Those hard numbers help make the evaluation meaningful and communicate to the organization what successful progress looks like.

We studied the use of ESG incentives at Fortune 200 companies last year. Of the 62% who disclosed such an incentive for senior executives, only 23% used an explicit standalone metric. The rest either considered ESG measures in a discretionary evaluation of individual performance (45%) or went with the scorecard approach (32%).

As for annual bonus vs. LTI, we recommend starting with the former. In that same survey, most companies with ESG incentives use them within the annual bonus only; fewer than 10% had adopted them in a substantial way in LTI. Here as well, as boards learn how these metrics work and grow comfortable setting longer-term goals, they can extend them to the LTI plans where ESG measurement naturally belongs.

The pioneers in these areas started with asking pointed questions, customizing ESG goals and metrics for their company, and measuring them. They began holding themselves accountable, and the board oversaw the process to make sure it happened. Eventually, where it made sense, they linked compensation to some of those metrics, along with other reward and recognition practices.

Like any bold corporate initiative, introducing ESG metrics in compensation brings serious risks. What if management misses its targets and take a hit on pay? Boards would have to disclose the failure publicly. Or what about management weakening the core business in order to achieve an ESG metric? The example of Danone is a cautionary tale: management and the board made ESG a priority, but then the financial results continued to lag, and they replaced the CEO in the wake of activist pressures.

These are real risks, which is why companies should walk before they run: First track the incentive for a while, then incorporate it into compensation. Or start with qualitative assessments and gradually move to harder metrics.

We expect investors and other stakeholders to push over time for more transparent and meaningful measurement, including in incentives, and for these incentives to have real variation in outcomes just like financial metrics. BlackRock recently released stewardship guidance on executive compensation, which references ESG metrics in incentives (short- and long-term). But boards have some flexibility now to take time to identify material ESG opportunities and risk, develop plans to address them and goals to strive for, and when, and if, the time is right, incorporate them in compensation. ■

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