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The Expanding Role of ESG in Executive Pay

By John Borneman, Blair Jones, and Kathryn Neel

Even before March, shareholders had a strong interest in the role of the corporation in society, especially on environmental, social, and governance (ESG) issues. While the COVID-19 pandemic has overwhelmed other considerations, ESG concerns continue amid heightened scrutiny of corporate behavior, and have intensified due to protests over racism and police brutality. Companies are increasingly weighing the broad social impacts of their decisions.

Stakeholder considerations are nothing new. Most directors and corporate leaders have long factored these societal considerations into their business practices, implicitly or explicitly. Nearly all CEOs would agree that fairly treating employees, customers, suppliers, and local communities is essential to long-term success. Nobody stays in business long by consistently neglecting their stakeholders. However, the nature of corporate social responsibility is changing amid recent discussions of stakeholder capitalism. The definition of stakeholders is expanding in scope to include a greater focus on the sustainability of both the individual business model and the broader economic system. Environmental protection, sustainable sourcing, equitable and inclusive employment practices, and paying a living wage are all increasing in prominence alongside traditional stakeholder concerns such as employee and customer satisfaction. Companies are being asked to stretch their ESG commitments for the long-term good of their economics and for society.

These issues have been integrated into regular boardroom discussions for many companies. Some boards even have a full committee dedicated to ESG. While businesses are still obligated to shareholders as providers of capital, they are beginning to more explicitly address the needs of other stakeholders. Formal ESG metrics can demonstrate a serious commitment to social as well as financial responsibilities, with attendant benefits to company reputation and employee culture. Many companies have now established these metrics through explicit goals and objectives, as well as greater transparency through corporate social responsibility reporting and proxy disclosures. For many, it's time to take the next step by incorporating ESG metrics into executive compensation plans. When done right, these sustainability objectives are tightly bound to a company's mission, strategy, and culture, and can drive meaningful change to the benefit of all stakeholders.

Why ESG Matters

Shareholders' increased scrutiny is not a passing trend, as is clear from BlackRock's high-profile call for key performance indicators

Social Consequences and Business Opportunities

Shareholder interest in ESG initiatives has risen after a series of prominent corporate disasters that affected society at large.

- **THE ENRON COLLAPSE (2001).** "A lot of people have suffered, not the least of whom are the shareholders and pensioners who lost it all," *Forbes* senior contributor Ken Silverstein observed in 2013. "It was a sad 'ending' to what had appeared to be a promising beginning to the New Economy in which the internet age would spread wealth and create jobs throughout the social spectrum."
- **THE FINANCIAL CRISIS (2007–2008).** In looking at the decade following the crisis, *Harvard Business Review* observes that "the most important effects of the financial crisis may be political and social, not economic. The years after the crisis saw sharp increases in political polarization and the rise of populist movements on both the left and right."
- **DEEPWATER HORIZON OIL SPILL (2010).** In *National Geographic's* recent examination of the repercussions of the largest marine oil spill in history, it referenced studies that show "that reef fish changed drastically after the spill; that fish absorbed some of the oil-sourced contaminants; and that ecological communities throughout the water column, from tiny bacteria to deep sea corals to arthropods, could take decades to recover."
- **#METOO MOVEMENT (2017).** According to *The Atlantic*, "#MeToo has been driven not by litigation but by mainstream and social media, bringing down men (and some women) as women (and some men) have risen up. The movement is surpassing the law in changing norms and providing relief that the law did not."

In addition to shareholders bringing these issues to the fore, there is a significant positive and strategic benefit to confronting the broader role of the corporation in society. Companies with a clear and expansive mission that includes a social element are known to have a more engaged and passionate workforce. These companies are more likely to have a strong employee value proposition and to compete successfully for top talent. Attracting talent will be more important than ever as the pandemic-induced shift to remote work broadens employment opportunities and, no longer constrained by geography, makes it easier for some people to move to other organizations. Those same companies can also better attract a diverse workforce, which brings different perspectives to the table and reduces the tendency toward groupthink.

Adding sustainability questions to the mix brings forward strategic opportunities while mitigating risks. For example, companies investing in strategic sourcing create better working conditions for suppliers, reduce environmental impact, and ensure the long-term viability of their supply chains. Coffee producers have long recognized this relationship, focusing on sourcing from and helping farmers with sustainable crop techniques and fair-trade guidelines, which has both ensured long-term supplies and improved the producers' reputation. Addressing sustainability issues material to the business can provide real and tangible benefits, and enhance growth and profitability over time.

Shareholders are not calling for abandoning the usual governance structures—just expanding the metrics in many cases. They still want boards and management teams to be held accountable for driving total shareholder returns over time. But they also want boards to demonstrate sensitivity to broader dynamics and long-term sustainability, and to put their money where their mouths are. Otherwise, they are likely to vote against individual directors on the relevant committees. Investors are pushing both for better performance and clearer disclosure. State Street Global Advisors has been vocal about ESG concerns, and has announced that it will independently assess companies on their ESG track records using its proprietary R-Factor scoring system. Investors are also looking for clear and comparable disclosure of ESG-related goals and progress, evidenced by the swell of petitions to the US Securities and Exchange Commission for updated rulemaking around sustainability risks.

Boards can be confident that ESG investments won't hurt conventional metrics. A great many studies have shown that paying attention to social and environmental concerns does not compromise financial returns. If anything, the opposite is true, according to a 2015 meta-study published in the *Journal of Sustainable Finance & Investment.*

for human capital management and environmental sustainability. Not only will BlackRock discuss these priorities with companies in outreach conversations, but if the money managers see no progress, they will also vote against committee and board members. The firm recently confirmed that it will push ahead with this plan despite the business disruptions stemming from the pandemic. Heightened attention from BlackRock and other institutional investors shows that ESG has moved from merely being a topic for intellectual discussion to an issue that demands concrete action.

Over the past several decades, we have seen evolving debate around the role of the corporation and corporate social responsibility, with the latest milestone perhaps being the Business Roundtable's 2019 statement that corporations should work for the benefit of all stakeholders. So, while an emphasis on sustainability is not new, this concept of stakeholder primacy is, relatively speaking. It remains to be seen whether conversations about broadening corporate responsibilities result in meaningful change, or, as some critics contend, if they are merely paying lip service or "greenwashing."

Some portion of this shift is certainly attributable to the backlash against specific corporate misdeeds. Recurring scandals and crises have highlighted the social and environmental risks associated with mismanagement or lack of oversight. The collapse of Enron, the financial crisis, the Deepwater Horizon oil spill, the opioid epidemic, and the #MeToo movement all had implications that extended well beyond individual firms and had broad social impacts. Corporate boards consequently have a role to play in overseeing the risks associated with management behavior and avoiding the significant reputational damage of misbehavior.

The Role of ESG in Incentives

With the growing pressure to make ESG commitments, more companies will likely include ESG objectives in executive incentive plans to further strengthen commitment and accountability. Indeed, studies indicate that more than half of S&P 500 companies already have some sort of ESG objective in their incentive plans, and prevalence among the largest companies is even higher.

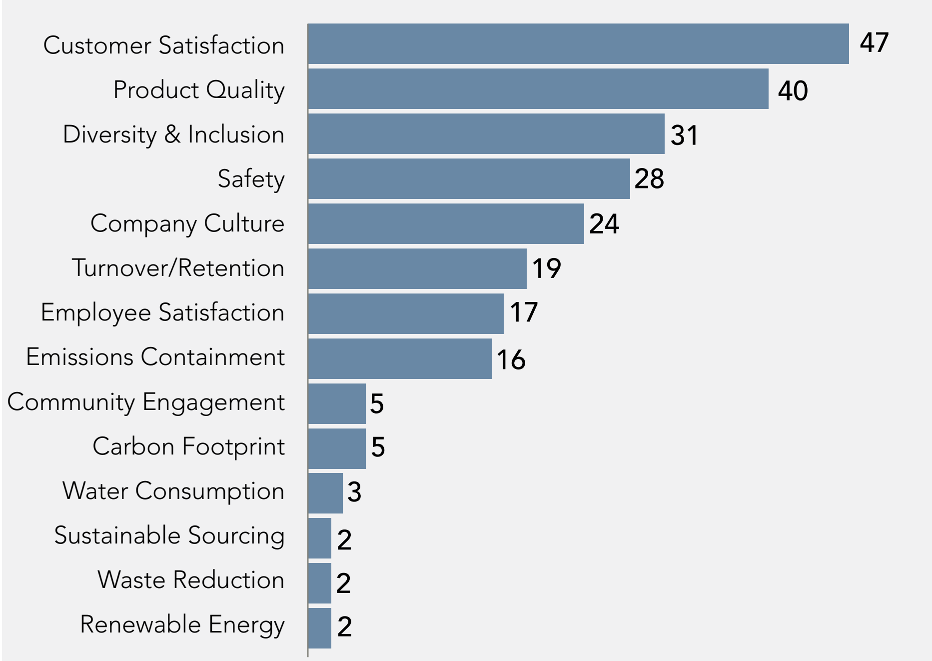
But if ESG metrics are already so prevalent, why are major shareholders calling for more commitment and more action? Don't companies already have a significant

FIGURE 1 Examples of ESG Metrics

Type	Risks	Opportunities
Operational (Traditional)	Workplace Safety Product Quality	Customer Satisfaction Employee Engagement
Sustainable (Contemporary)	Gender Pay Equity Greenhouse Gas Emissions	Diversity and Inclusion Sustainable Sourcing

FIGURE 2 Prevalence of Specific Incentive Metrics

Reflects the percentage of Fortune 200 companies with ESG measures in incentives reporting for each type



Source: Semler Brossy Consulting Group *ESG + Incentives Report 2020* focus on other stakeholders in incentive plans? Here, it's important to distinguish between different types of ESG metrics and how they are used in incentive plans. Many current ESG metrics focus on operational needs and are part of good business management—and companies have measured these elements for decades. But shareholders today are looking for companies to address broader social impacts and long-term sustainability (*see Figure 1*).

In the past, ESG centered on improving relations with customers and employees, while minimizing negative outcomes such as workplace injuries, pollution, and angry customers or community activists. As a result, the vast majority of ESG incentives still address short-term measures of direct stakeholder impact, such as customer and employee satisfaction and workforce safety. With the exceptions of diversity and inclusion and company culture, broader metrics of social impact are rare. In addition, measures of environmental impact are extremely limited (*see Figure 2*).

As the debate about corporate responsibility for broader social good continues, ESG metrics will increasingly be applied to larger concerns around sustainability. Boards will need to consider societal outcomes, such as paying living wages, the impact of operations on communities, and boosting environmental resilience. To gain traction here, companies will need to become more sophisticated in tracking these long-term outcomes and in devising rewards for progress.

Including ESG in Rewards

Boards don't need to attempt action on every ESG concern. BlackRock points out that "ESG factors relevant to a company's business can provide essential insights into management effectiveness and thus a company's long-term prospects." Boards should start by deciding which ESG factors are most strategic for their businesses. The strongest metrics will have a clear sustainability element while linking closely to the company's purpose and creating clear benefits for the business, its employees, and its shareholders. Metrics that are both good for the world and good for business will always have more support and engagement from business leaders.

Boards can start by selecting objectives that have all of the following attributes:

1. **Core to the business.** Is the objective closely tied to the company's purpose, capabilities, or market?
2. **Strategic.** Will strategic investments pay off in the long term in greater revenue or profitability, lower risk, or a stronger competitive position? Will metrics capture the recruitment (and the retention) of talented recruits, whose commitment will give the investments a higher likelihood of success?
3. **Measurable.** Can the board establish accountability and rewards?

An energy firm, for example, might invest heavily in decarbonization, acknowledging the long-term market transition away from fossil fuels. A consumer foods company might focus on sustainable sourcing, which would protect and diversify its supply chain. ESG initiatives that tie into an existing company mission statement would add the benefit of strengthening the overall corporate culture. A food-service company with the mission of feeding the world, for example, might support local anti-hunger initiatives.

All of these metrics clearly support the business while bringing societal benefits. In this context, ESG becomes more than a response to external pressures. It is also an opportunity to realize greater value in the long run.

Once boards have clarified which ESG metrics are important for the company, they can incorporate them into incentive compensation plans. Directors have many reasons for doing so, including

- signaling ESG's importance to shareholders, employees, and society at large;
- changing the culture of the organization among leaders and more broadly;
- managing inherent business risks tied to ESG issues; and
- pursuing strategic opportunities linked to ESG.

As with most incentive plan objectives, the key is clarity on what the metrics aim to accomplish. Boards will structure and weigh ESG incentives differently depending on which of the above rationales matters most.

But even with clear objectives, it's difficult to measure ESG outcomes in a way that meaningfully aligns pay with performance. This is especially true of metrics for long-term social and environmental sustainability. Meeting most of these objectives might take many years, and meaningful progress might not be made even over a one- or three-year time horizon. Sustainable sourcing, decarbonizing operations, or increasing the diversity of business leadership all require continued intentional investments over many years. Most boards prefer to reward results rather than activity, but progress is often unclear over short periods.

Even for short-term goals, success is often highly subjective and difficult to measure. Operationally, we know that increasing sales and reducing costs lead to improved profits, which in turn creates value for shareholders. Those are controllable metrics, directly linked to desirable business outcomes. But how much carbon reduction is enough? What is the end goal for diversity and inclusion? How should these important objectives be prioritized relative to other corporate goals and investments? Companies may also balk at setting targets because it makes success or failure a black-and-white issue; they certainly wouldn't want to report missing targets around sensitive social or environmental issues. These challenges have no doubt slowed the integration of ESG goals into incentive plans.

Finally, boards may decide against offering a reward with every ESG objective. Some goals, they might argue, should be pursued because it is the right thing to do and good for the company over the long term. Do we need to pay people to work toward eliminating gender pay gaps? Should executives be rewarded for minimizing spills of damaging chemicals or wastes?

As a result of these challenges, companies use a range of measurement approaches and apply them in different ways depending on their unique context. Most of these approaches work for either short-term or long-term incentives, depending on the time frame and issue (*see Figures 3 and 4*).

Many companies include sustainability objectives in incentives only as part of individual performance assessments and as a modifier to incentive plan payouts. That's not surprising, given the challenges in measuring social or environmental impact. But the incentive and signaling effect of individual performance modifiers are often muted, and they can get lost in a largely discretionary assessment. While individual modifiers are still a good starting point, they're limited in driving real change. Investors and other stakeholders are likely to continue to demand greater degrees of accountability and transparency.

Although structuring ESG incentives is challenging, it can be done in a way that provides both rigor and clarity. As is often the case with social and governance changes, examples of market-leading practices can be found in Europe. For example, Danone has included sustainability metrics in its incentive plans since the 2017 launch

FIGURE 3 Measuring ESG in Incentives

Measurements	Potential Usage	Examples
Individual Assessment ESG goals are often integrated into performance assessments based on individual objectives established at the beginning of the year. These assessments are often a more subjective component of executive rewards and are generally used to adjust payouts rather than drive the overall level of incentive pay.	■ For goals and objectives that may not lend themselves to a single, clear measurement of success ■ Where specific executives are responsible for achieving individual objectives, rather than the team as a whole ■ When goals have a less tangible impact on business risks and results	■ Creating an effective leadership culture ■ Supporting diversity and inclusion initiatives ■ Driving the company's renewable energy strategy
Performance Scorecard Metrics are often added to a scorecard of goals that have a material impact on incentive results, generally worth a collective 20–30 percent of payout. These may be qualitative or quantitative, but the assessment of performance typically includes a degree of judgment.	■ Where goals can be explicit but still require judgment in assessing results ■ For activity-based objectives where the quality of the results matters as much as the quantity ■ To promote a sense of collective ownership ■ For goals that are more directly aligned with strategic opportunities and risks	■ Women and minority new-hire and promotion target rates ■ Impact of community service initiatives (e.g., number of students trained, public health improvements) ■ Employee engagement survey results
Discrete Metrics ESG metrics included as one or more discrete measures that are weighted and measured separately, similar to financial or operational objectives.	■ Where ESG objectives are essential to the business mission and strategy ■ When clear progress can be linked to improved business results ■ For goals that are quantifiable and distinct	■ Fuel efficiency per mile driven ■ Percent reduction in greenhouse gas emissions ■ Percent recyclable packaging

of its "One Planet. One Health" initiative and mission to "bring health through food to as many people as possible." Danone included the metrics as discrete measurements, carved out within both the annual and long-term incentive structures. While not weighted as heavily as economic results, the explicit callout and meaningful weighting of these goals places them on par with financial objectives as important business results to be managed.

Corporate social responsibility is not new. Business leaders have always viewed stakeholders as important constituents for long-term corporate success. But in recent years, investors have prodded boards to expand the definition of stakeholder beyond the immediate periphery of the company, its employees, and its customers. Now, corporations also need to consider their environmental, economic, and social impacts. These broader metrics of corporate sustainability are at the heart of shareholder concerns over ESG in today's governance discussions.

As the focus on sustainability grows, more companies will seek to develop strategically meaningful ESG goals and objectives. For many, the next logical step is to address the role of ESG—and especially of environmental and social metrics—in executive compensation plans.

And, as more companies give shape to how ESG issues impact their businesses over the long term, ESG incentive metrics will expand and become more sophisticated. Ultimately, this will enable corporations to tightly bind their executive incentives to their strategy and mission, and more broadly, to their impacts on the environment and society. D

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FIGURE 4 Applying ESG in Incentives

ESG Applications	Potential Usage	Examples
Separate Carveout ESG metrics are a fixed percentage of an annual or long-term performance plan, so the level of funding depends on the assessment of performance.	■ For ESG objectives tied closely to improved business outcomes or critical to strategy ■ Where objectives are highly measurable	■ A hospital company measuring patient care quality as defined by the Centers for Medicare and Medicaid Services ■ An oil and gas company measuring the greenhouse-gas intensity per ton of product sold
Performance Modifier Results are used to adjust the core business metrics within a specific range. Sometimes used as a negative modifier only.	■ When objectives are important but secondary to core business objectives ■ When measures may be less quantifiable, or hard to measure	■ Apparel company investing in responsible sourcing ■ Consumer packaged goods company investing in non-animal testing ■ Medical device company with a downward modifier for missed quality objectives
Performance Kicker Results can increase but not decrease incentive payouts; generally used for outperformance rather than just accomplishing an expected result.	■ For aspirational goals that might be hard to achieve in a given time frame ■ As a reward for "doing the right thing" at an accelerated pace or to an extraordinary extent ■ May also be for discrete initiatives	■ A food distribution company hitting an extraordinary community service target for alleviating hunger ■ A beverage company hitting its clean water sourcing targets two years early
Relative Performance Results relative to a set of peers or another external benchmark. Could be part of a carveout program or a modifier.	■ Where goal-setting is difficult or may not be meaningful if defined as an absolute metric ■ Where a strong comparable benchmark is available Note: Standardized metrics and benchmarks may be difficult to set today, but should expand over time.	■ Percentage of women and minorities in leadership positions compared to industry peers ■ Percent of power supplied by renewable energy sources relative to industry benchmarks