Pearl Meyer

ADVISOR BLOG

# ESG and Executive Compensation in the UK and Beyond


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Worried about extreme weather? Diversity of opportunity? The way in which big business is run? Relax, you are not alone.

Environmental, social, and governance issues—or "ESG" for short—are playing on the minds of investors in a very big way. As a result, ESG is high on the agenda of most company boards and is beginning to play a very big part in the design of incentives in the UK.

Nearly half of all FTSE 100 companies now have an ESG measure in their annual bonus or long-term incentive plan[1]. Investors want it, customers and suppliers expect it, and regulators demand it. Some investors are even looking for a separate vote (independent of say-on-pay) on ESG measures by 2022, and a new listing rule will require UK Premium listed companies to disclose whether and how their remuneration arrangements incorporate environmental performance metrics that are aligned with "The Taskforce for Climate-related Financial Disclosures" (TCFD) or explain why not, and what their action plan is.

Just how much of a change is this, and how important is this change to those tasked with making the decisions around executive pay?

Fundamentally, people do what they are paid to do. We have known that for a long time. So, in the last 20 years or so, the focus has been on simply making executives and the way they are paid more accountable, more aligned with what shareholders expect. As a result, we have seen huge increases in performance-related pay, particularly long-term incentive pay. For example, by 2020, various studies show that over 75% of long-term incentives in FTSE 350 companies were linked to improvements in total shareholder value. Given this fact, it is not surprising that executives are focused on growth, because growth drives returns to shareholders.

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[1] https://www.ft.com/content/609eae5e-1576-4081-9340-5d5001b5b02e

But growth comes with direct and indirect costs. In terms of carbon in the atmosphere, plastic in the oceans, and many other environmental impacts, the cost is particularly apparent to a younger generation that must eventually bear that cost. By 2025 the younger generation will comprise the bulk of the workforce and they will also be investors themselves, driving global investment decisions.

Fundamentally, the idea that we should ask companies to be more responsible is not new. For example, a beleaguered mining company was excluded from Norway's sovereign wealth fund due to environmental concerns in Indonesia. What has changed is that a new generation of investors and consumers, perhaps further fueled by a collective sense of grievance engendered by the global pandemic, is highlighting environmental problems and social inequalities that already existed and demanding action.

The result is that to ignore ESG now is to increase business risk. Delivering on ESG improvements is setting a bar for a license to operate and getting it wrong will cost directly (a recent emissions scandal cost upwards of $12B), and indirectly in damage to corporate reputation. ESG credentials are no longer a "nice to have" item at the bottom of a CEO's list of priorities. They have become part of the long-term value creation process. Accountability for meaningful progress against an ESG agenda must be a good thing in principle, but how do you build an incentive plan that signals virtue without the perception of hollow "virtue signaling"?

Remuneration committees are faced with multiple questions:

- Where do you start to evaluate which measures are most applicable when there are hundreds to choose from?
- Is it necessary to monetarily incentivize action against the identified measures?
- What does "good" progress look like and how is it measured with confidence?

To begin, in many cases, having an ESG metric in incentive programmes makes perfect sense where it's already entwined with the creation of shareholder value. Companies in certain sectors (for example energy, chemicals, or utilities) have had measures in their annual bonus plans for years, albeit along the lines of more "traditional" measures, such as health and safety. A good place to start the deliberation is to look at key performance indicators which drive annual bonus. Focus on those that are strategic or linked to purpose. Doing this will help choose metrics that are authentic and unambiguous. These can take the form of "input" measures, which tend to be qualitative such as tracking diversity or employee engagement, or "output" measures, which are quantitative such as $CO_2$ emissions or recycling rates. (Investors, not surprisingly, tend to be more comfortable with quantifiable "output" measures.)

Once you have some ESG metrics in your sights, consider how easy or difficult it will be to set targets, to measure, and track.

Another factor to bear in mind is where the company operates. In the US, climate is likely to be the biggest focus for 2021 and beyond, with diversity, equity, and inclusion metrics continuing to gather momentum. In Western Europe, given existing tough regulations on emissions, many companies have already added measures on environment. In Latin America, there is focus on environmental measures but also a focus on DE&I, as well as employee wellbeing and safety. In Asia Pacific, the main focus is on governance issues such as board diversity and skills, formal NED selection, and board effectiveness. This is particularly notable in Japan, Singapore, and Hong Kong.

Having identified potential measures, consider how ready the organisation is to include ESG measures in executive pay. Is it the right decision in all cases to link ESG to executive pay, or can the same results be achieved by simply tracking progress? Might a decision to incorporate the goal into a pay programme inadvertently place attention on ESG, but at the risk of losing focus on other measures?

Having agreed the types of measures, and having accepted a link to incentive pay, the next step will be to determine how they should be incorporated in an incentive plan. There are numerous programme design options here:

- Standalone measures tend to be used by organisations with very clear, and generally quantifiable, ESG goals. The higher the weighting, the stronger the message on accountability.
- Companies earlier in this ‘journey’ may prefer a scorecard of four or five measures linked to a weighting within an incentive plan. (For example, one public energy company incorporates two ESG measures in its annual bonus score card accounting for 20% of its overall scorecard.)
- “Modifiers” can be used to increase or decrease the overall award pay-out. These work best when quantifiable and transparent. (A huge technology company announced earlier this year that it will use ESG as a modifier to its executive annual bonus.) Companies wishing to signify the overall importance of an ESG measure can use an underpin or hurdle, such that the incentive plan cannot even begin to kick in until the ESG goal is met. (A UK-based financial services firm favours underpins rather than scale targets.)

While incorporating ESG measures may be challenging, it is exciting to be part of this change in emphasis that is being experienced by all businesses. In the end, investors are listening to a wider audience and companies are aligning the way managers are paid so they do what investors expect.

It will be worth getting this right. Not only will it bring huge benefits for all of us, it will help drive additional investment.

## About the Author

Simon Patterson is a managing director and head of the firm's London office. He is actively engaged as advisor to the remuneration committees of several FTSE 100 companies and consults widely on executive compensation, incentive compensation design, and performance measurement.

## About Pearl Meyer

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