Building ESG Into Your Incentive Plans

by Peter Schloth and David Cahn

Environmental, social and governance (ESG) measures are taking over the world of investor activism, driving corporate change—and shareholder votes. While boards weigh policies to add ESG objectives to company strategy, however, they may overlook a powerful implementation tool—executive pay plans that support corporate responsibility.

Human resource professionals and board advisors see the growing urgency to address environmental, social, and governance (ESG) priorities at the executive and board level. An early proponent of ESG was Nobel Laureate and former UN Secretary General Kofi Annan. In 2006, he was joined by some of the world's largest investors in adopting the *Principles for Responsible Investment* that advocated incorporating ESG issues into investment practice.

Thirteen years later, BlackRock CEO Larry Fink made similar arguments in support of ESG priorities and a corporate purpose that goes beyond profits. In his 2019 CEO letter, he writes: "Purpose is not a mere tagline or marketing campaign; it is a company's fundamental reason for being—what it does every day to create value for its stakeholders. Purpose is not the sole pursuit of profits but the animating force for achieving them."

We are in the midst of the mainstreaming of ESG to make companies more accountable for actions that have an impact on the environment and social issues.

ESG encompasses a broad range of topics, from addressing climate change (environmental) to improving employee engagement and pay equity (social) to promoting board diversity (governance). Whether these topics should be lumped together is debatable, but given investor interest and opportunities to mitigate risk and realize competitive advantages, understanding how ESG fits into business strategies and operations is imperative. This includes if and how incentive compensation should be structured to support ESG initiatives.

This article outlines some of the catalysts driving the "mainstreaming" of ESG, the prevalence of ESG incentive plan metrics, methods for linking pay to ESG goals, and frameworks executives and boards can use in thinking about how ESG metrics might be incorporated into board operations and incentives.

We are in the midst of the mainstreaming of ESG, making companies more accountable for actions that have an impact on the environment and social issues. Events demonstrating this include:

☐ ***Institutional investors are stressing the importance of social issues.*** BlackRock and State Street have made human capital management and corporate culture investment priorities.

In his annual letter to shareholders, Blackrock CEO Larry Fink lists his investment stewardship engagement priorities for 2019: governance, including a company's approach to board diversity; corporate strategy and capital allocation; compensation that promotes long-termism; environmental risks and opportunities; and human capital management.

Similarly, State Street's 2019 letter focuses on "good governance and other practices that affect a company's ability to generate positive returns for investors over the long run. Those issues span a variety of environmental, social and governance (ESG) topics material to sustainable performance."

☐ ***Increasing support for ESG shareholder proposals.*** A June 2019 review of shareholder proposals

Peter Schloth *and* **David Cahn** *are principals at consulting firm Mercer. [www.mercer.com]*

by proxy advisory firm Institutional Shareholder Services (ISS) found that the number of environmental and social proposals receiving more than 30 percent support rose from 28 percent in 2017 to 48 percent in 2019, while the number of governance proposals receiving more than 30 percent support held steady at around 60 percent.

In addition, while not reflected in the votes, a record 48 percent of environmental and social shareholder proposals were withdrawn—indicating that these companies likely engaged directly with shareholders to address their concerns.

☐ ***ESG ratings and scorecards are proliferating.*** Proxy advisory firms are pressuring companies to adopt ESG voting policies and develop ESG scorecards to inform their voting recommendations. Institutional investors are also relying on third-party ratings providers (such as MSCI) to help them fulfill their investment stewardship priorities.

☐ ***A push for increased U.S. ESG disclosures.*** The SEC's Investor Advisory Committee recommended in March 2019 that disclosure of human capital management practices (workforce diversity, turnover and training, employee safety and satisfaction) be required. Human capital disclosure is already required in the United Kingdom.

Also, the Task Force on Climate-Related Financial Disclosures has developed recommendations for consistent climate-related financial risk disclosures for use by companies. Support for the recommendations has grown to 785 of the world's leading organizations (up from 513 in September 2018).

☐ ***Company executives are concerned about ESG.*** According to *Mercer's 2019 Global Talent Trends Study,* nearly 40 percent of executives are concerned about corporate responsibility to address societal issues (almost double last year's rate). Sentiment analysis and engagement surveys are on the rise with 32 percent of respondents surveying employees twice a year, and 22 percent doing it more regularly. A top concern for executives is delivering on diversity initiatives, and for good reason. Thriving employees are four times more likely to work for a company that delivers on diversity and equity in pay and promotions (78 percent vs. 18 percent).

Whether and how to use ESG incentive metrics may become integrated with mission/vision, company strategy, operations, and incentive pay plans.

The mainstreaming of ESG combines with the increasing number of questions we have heard from clients. This suggests that whether and how to use ESG incentive metrics may soon be integral to discussions about mission/vision, company strategy, operations, and incentive compensation plans.

Mercer surveyed 135 organizations in the United States and Canada and found that 30 percent use ESG metrics in incentive plans, most commonly in short-term plans (21 percent), followed by in both short-term and long-term plans (7 percent), and just in long-term incentives (2 percent). Another 21 percent of companies are considering using them in the future, bringing the total that currently use or are considering using ESG metrics to 51 percent.

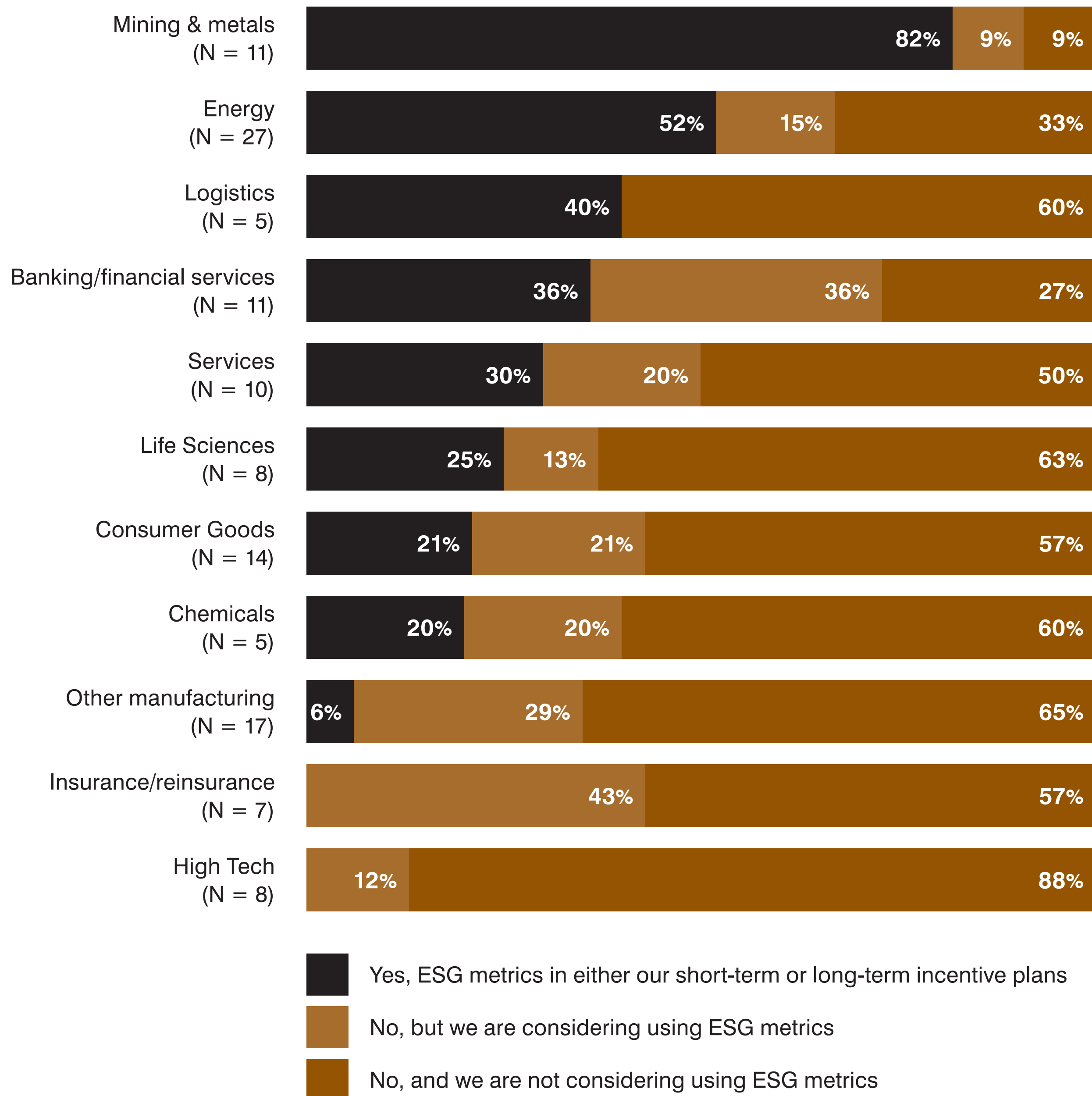
Industry sector has a significant impact on whether or not ESG metrics are being used in incentives. The mining and metals and energy industries most commonly use ESG metrics, while none of the insurance and high tech survey participants include them. This might change, though, with 43 percent of insurance firms considering using them.

Industry also influences the types of ESG metrics used. The mining and metals and energy industries most commonly use environmental metrics (96 percent), while other industries most commonly use employee engagement/culture metrics (76 percent).

This aligns with our experience working with companies in environmentally intensive industries. These have a long history of using environmental impact metrics (e.g., accidental spills, pollution levels) for risk mitigation because their business models rely heavily on the use of natural resources while protecting the environment. Outside of these industries, ESG metrics are more commonly focused on improving employee engagement, pay equity, promoting diversity and inclusion.

Some of the most common ESG metrics include:

☐ ***Environmental ESG metrics.*** Industry type can impact the environmental metrics used. Metrics for



the mining and metals and energy industries include environmental spills and violations, workplace safety and water usage.

Metrics for other sectors outside of the mining and metals and energy industries include carbon footprint, energy efficiency, and waste reduction.

☐ ***Employee engagement ESG metrics.*** An engaged workforce is critical to company success and to value creation for shareholders. According to *Mercer's 2019 Global Talent Trends Study,* the top

human capital risks facing companies are decline in employee trust and increase in employee attrition. U.S. executives responding to questions about which talent analytics would add the most value ranked employee burnout as number one. Given these findings, a focus on employee engagement seems warranted. Examples of employee engagement metrics include:

- Employee engagement surveys and comparisons of year-over-year changes in results.
- Voluntary terminations.
- Learning and innovation milestones.

☐ ***Diversity and inclusion ESG metrics.*** *Mercer's 2019 Global Talent Trends Study* also identified workforce and leadership diversity as key priorities, which supports a focus on diversity and inclusion metrics. Examples include:

- Percent of women and minorities in leadership positions or entire workforce.
- Gender pay equity.
- Supplier or contractor spending on minority and female-owned companies.

There is no standardized set of rules or commonly-accepted standard setting body (like the Financial Accounting Standards Board for financial accounting) that can be used to set ESG goals. Therefore, we see a variety of approaches to ESG goal setting.

A majority of companies set quantitative goals (71 percent for short-term incentives and 61 percent for long-term). However, qualitative assessments are fairly common, most notably for diversity and inclusion metrics. We also know from experience that companies commonly consider ESG related goals as part of individual performance evaluations on a qualitative basis.

Consider how ESG fits into your company's purpose, strategy, and operations. The focus is moving beyond risk issues into value creation and competitive advantage.

The variety of approaches to goal setting indicates that the type of measures and each company's unique circumstances will inform the approach that works best for them. We expect that approaches to goal setting will evolve over time, potentially to more standardized and generally accepted models.

We suggest that all companies consider how ESG fits into their purpose, strategy, and operations. We currently see varying degrees of focus on ESG, with some companies giving it very little or no attention. Leading companies interested in ESG for many years are moving from a focus on risk mitigation (limiting the cost of environmental impact and discrimination lawsuits) to a focus on value creation and gaining a competitive advantage through integration of ESG into business strategies.

For example, many organizations accept that workplace diversity is a way to create more innovation and more effective corporate cultures. Similarly, the consideration of environmental impact or benefits brings innovations in product development and improved long-term returns on capital projects.

A likely outcome of a sustainable business strategy is a focus on the ESG initiatives and measures that best reflect long-term success. Broad scorecards applied in investment analyses may be helpful in supporting that purpose, but incentive pay plans should generally focus management's attention on the highest priority performance outcomes. The relative importance of each metric should be ranked after considering its role with respect to corporate purpose, strategic importance, industry prevalence, and investor interest.

The best metrics should have the potential to enhance employee engagement and innovation, and create shareholder value. We suggest focusing on the one or two ESG metrics that are expected to have the biggest impact, then reassessing with experience and shifting prominence, as appropriate.

☐ ***Roadmap for executives.*** Executives can use the following five-step approach in evaluating how to best integrate ESG performance into business operations:

- *Step 1.* Determine and document the relationships between purpose, strategy, and ESG.
- *Step 2.* Develop ESG scorecards relevant to the business and its industry, considering whether a focus on environment, social, and/or governance issues is most appropriate. Collaborate with stakeholders to set measurable goals.

□ *Step 3.* Consider alternatives for linking the scorecards to pay.

□ *Step 4.* Communicate and educate stakeholders. This may require substantial effort if ESG has not been part of the company lexicon to date. Be transparent internally and externally.

□ *Step 5.* Iterate and evaluate the effectiveness of current/planned practices and revise as needed. Stakeholder expectations and competitive dynamics can change rapidly, requiring agility.

□ ***Roadmap for directors.*** With stakeholder dialogue and expectations regarding ESG on the rise, boards may need to help drive management attention to ESG. Seek active governance and board operation in this arena. There are several potential implications:

□ *Board and committee charters.* The board should clarify its role in monitoring management action relating to sustainability and ESG. If not already done, a committee should be selected to lead the board's sustainability efforts and the committee charter should be prepared and updated accordingly. These duties, and their delegation, should be communicated to all stakeholders.

□ *Director qualifications.* ESG expertise may be largely uncharted territory and the skills most relevant to the company's unique ESG imperatives may need to be considered for new and incumbent directors. Boards may need to recruit new directors with ESG expertise, and develop training programs.

□ *Regular review.* Board review of ESG initiatives, how they relate to business strategy, and progress against goals should be a recurring agenda item. Review of board and committee calendars and meeting operation may be needed as agendas lengthen and competition for director attention intensifies.

□ *Mandate action.* While a growing number of companies have introduced sustainability and ESG measures into the management dialogue, some early efforts are largely aspirational. Goals and operating plans require specificity, and failure to deliver results should have consequences. This is a key responsibility for the board in discharging its duties and realizing the potential value of ESG.

In conclusion, companies are responding to growing pressures to address ESG issues by looking for ways to minimize environmental impact and create more engaged and diverse workforces that drive innovation. In the years ahead, we expect more companies will evaluate ESG performance frameworks and link them to pay as investors, customers, and other stakeholders increase their focus on ESG.

However, linking ESG performance to pay will not by itself create lasting change. Diligent governance, a thoughtful strategy that integrates ESG considerations, strong operational linkages, well-constructed performance management systems, and effective communication are all required for success. ■

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Okemos, MI 48864-2414, (517) 336-1700
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