EXECUTIVE PAY

Take ESG Compensation Metrics to the Next Level

By John Borneman and Kathryn Neel

Companies are increasingly attending to environmental, social, and governance (ESG) issues, including by using ESG metrics in executive compensation. Spurred in part by the pandemic and the social protests of the past year, shareholders are calling for greater disclosure and commitment to ESG matters, and some are explicitly asking companies to include at least one material, measurable ESG metric in their executive pay plans. This pressure will only increase as more activist investors identify ESG issues as a new line of attack and as ESG-focused investment funds continue to grow.

At year-end 2020, 57 percent of S&P 500 companies tied some ESG metrics to executive incentives. A newly released Semler Brossy report on ESG incentives found that 51 percent of S&P 500 companies overall use operational metrics with an element of ESG, including, for example, those related to safety; 38 percent use sustainability metrics such as those related to diversity, equity, and inclusion (DE&I); and 34 percent use both sustainability and operational ESG metrics.

Are investments in customer satisfaction, employee safety, and talent development—three of the four most popular ESG areas to focus on in executive pay—really just business as usual or advancements in ESG accountability? How can boards introduce incentives with a real impact on business and society?

WHAT PAY INCENTIVES CAN DO

As some observers have already pointed out, the best approach starts with a clear understanding of the limitations of compensation programs. Incentive pay accomplishes little without a larger initiative and supporting structure in place at a company. If not seen as a critical business issue, executives might ignore or game the metrics, just as they might do with financial or strategic goals.

To prevent this outcome, boards must reflect on what is important to the company. Take DE&I, the most popular of the nonoperational ESG metrics. If a board decides that greater DE&I is imperative, then an executive pay incentive is just one element of the response. The company will want to promote it with all the levers at its disposal to ensure change occurs, through performance management programs, succession planning, and corporate culture initiatives, for example. The company can do this the same way it might develop a multipronged strategy to improve returns on invested capital.

Once commitments and processes are in place, it then may make sense to reinforce them with a strong DE&I metric in executive pay. If the board and management are unwilling to invest time, resources, and capital into these larger initiatives, then a DE&I incentive in pay is mere window dressing.

The primary goal of incentive measures is to reinforce the messaging of company values and strategy, which does not require high prominence in pay to be effective. Especially in these early years, it makes sense to proceed carefully and tie only a small part of pay to meeting DE&I goals, for example, which may be new to an organization and not fully tested.

Indeed, many of the S&P 500 companies that use ESG incentives have set them up as lesser elements for individual or discretionary evaluation, especially when it comes to socially oriented metrics. Apple, for example, added a general ESG modifier to its annual executive bonus, with the compensation committee holding discretion to adjust individual payouts by 10 percent in either direction according to the executive's performance against these goals. Some boards have experimented with human capital scorecards where DE&I is but one of several key indicators of progress, with pay linked to the aggregate result of the scorecard.

PRINCIPLES FOR EFFECTIVE ESG INCENTIVES

Only when ESG issues are part of the larger corporate agenda should boards introduce ESG metrics into pay. Effective metrics should be

- tied to measures already in use in the business and essential to the company strategy;
- supported by a clear rationale on benefits to shareholders;
- objectively measurable;
- consistently applied over multiple years; and
- readily disclosed publicly on an ongoing basis.

Without a consensus for action from the board and management, incentives will have little impact on behavior. Discomfort with or an inability to apply the five principles above is a valuable reality check about a company's readiness to incorporate ESG metrics into executive pay programs.


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