Should ESG Metrics Be Included in Executive Incentive Plans?

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Environmental, social, and governance (otherwise known as ESG) topics are of critical focus among the investment community, including targeted funds, and for good reason. As investors become more socially responsible and environmentally aware, they are increasingly looking to invest in companies that track and report their high environmental and ethical standards. While it may seem like common sense to work in an ethical manner, today's investors, especially those who are new to investing, want to support companies that demonstrate strong values. As a result, companies are being asked to provide the investment community with enough information to assess their ESG progress in a transparent way.

In addition, many investors are pressuring companies to go beyond disclosure of ESG initiatives and consider the appropriateness of tying the payouts under incentive plans to the achievement (or lack thereof) of such goals. However, many companies are still trying to determine the following:

- Which ESG metrics are most important for their business;
- Which metrics are measurable and what standards should be considered;
- How certain metrics have been tracking over time;
- What the appropriate time horizon is;
- Whether there any unintended consequences that should be considered; and
- What has already been communicated publicly.

Some companies are questioning whether ESG metrics warrant being paid for, or if they should instead be woven into the overall values of the organization as part of their broader sense of purpose in hopes of attracting and retaining the right talent and remaining competitive in today's market. Treating the environment and community well are keys to creating and maintaining a competitive advantage. So, while identifying and measuring progress towards ESG goals may be critical to aligning interests to that of a broader set of stakeholders, it may not necessarily require a change to incentive plan designs.

Why Incorporate ESG Metrics Into Your Incentive Plan?

Investors are more conscious today than ever before about the importance of responsible organizational governance; they want to know how businesses are incorporating ESG into their current strategic objectives as well as how they plan to continue doing so in the future. In addition to increased engagement on the topic, shareholders have submitted over 400+ proposals related to ESG in each of the 2019 and 2020 proxy seasons. While support for these proposals is still limited (with only approximately 12% receiving majority support in 2020), it is clear that investors, especially those in the younger age brackets, are becoming increasingly more socially and environmentally conscious. As a result, investors are wanting companies to become accountable for progress made towards ESG initiatives that they deem important.

One way for organizations to demonstrate accountability and show support is to align financial interest of senior leaders to achievement of specified goals. However, just because it is viewed as an important management initiative – doesn't mean it has to be included in executive incentive plans.

For some companies, it may make perfect sense to tie pay to ESG metrics. Certain industries have clearer ESG initiatives that are already measured, tracked, and disclosed, such as utilities and energy (e.g., greenhouse gas emissions, carbon footprint reduction, safety) and consumer products companies (use of recycled materials, packaging waste reduction, water replenishment, sustainable sourcing, reduction of sugars, etc.). However, for other companies that are just in the beginning stages of assessing the impact of ESG, it may be too soon to consider including such metrics into pay programs. However, in either case, it is important to identify critical focus areas for your organization, understand your current state, and increase transparency, both internally and externally.

Measuring ESG

ESG embodies a wide variety of metrics, ranging from those focused on environmental and sustainability, people and HR, health and safety, customer engagement, diversity and inclusion, and governance. Despite external benchmarks (e.g., SASB), there is limited standardization across companies on how to define, measure, and report progress against ESG goals. In many instances, companies are still trying to understand their baseline statistics on how they are currently performing on the ESG continuum – and which metrics may require further attention. However, regardless of where your company falls on this spectrum of understanding which ESG metrics may be of most importance to your business strategy, having the conversation with your Board is an important first step.

There are few internationally accepted ESG standards to date, leaving companies with the burden (and the freedom) to define their own. Many companies are thinking about "progress towards" certain objectives – given the longer-term nature of achieving certain objectives. For example, utilities are working toward carbon emissions reduction goals over the next 10 to 15 years – with goals set out to be achieved over that same time period. However, those same companies are thinking about yearly progress toward those longer-term objectives – some of which have incorporated such statements into their incentive plans for executives.

In addition, diversity and inclusion (D&I) is a hot topic of late, given the social unrest that exists across the U.S. – which has led to some companies including things like improvement in representation and relative pay of women and minorities or indices that include supplier diversity, workforce diversity, and other metrics as a goal in their bonus programs.

While some companies have included specific ESG metrics into their incentive plans, typically in annual bonus programs, most have done so as part of a qualitative component – either as part of a broader scorecard of items measured subjectively or as one of many ways to assess individual performance. When included as a quantitative component, ESG metrics are often weighted 10% or less – which can be viewed as not as impactful given the heavy weight typically given to financial metrics like earnings.

Conclusion

While ESG is a rapidly evolving topic, it encompasses traditional principles that companies have worked to uphold for decades. The key to approaching ESG is to help investors understand what is already being done within your organization and how it impacts shareholder value. ESG is a critical consideration for all organizations, and investors are likely going to continue to push companies to focus on it, but it doesn't necessarily have to find its way into executive incentive plans.