Incentive Pay Design

Weighing ESG Metrics for Pay Plans

By Annette Leckie

If your conscience is bothering you because your board hasn't added environmental, social, and governance (ESG) metrics to executive incentives, that's a good thing. It means you care about the culture and governance aspects of your company and the future of our planet. However, it does not necessarily mean you must immediately add ESG metrics to your incentives. Changes to incentive plans need to be carefully considered, and new metrics should be weighed against the appropriateness of other measures.

In 2019, 181 CEOs signed the Business Roundtable's Statement on the Purpose of a Corporation and committed to leading their companies for the benefit of all stakeholders, which includes customers, employees, suppliers, communities, and shareholders. As a result, and due to growing interest in ESG metrics among major US investors, companies are under increasing pressure to demonstrate a broader sense of purpose through their incentive plans.

Currently, ESG metrics are often used in industries where these pressures from investors have been most pronounced (e.g., energy, utilities, large branded consumer products, etc.). Metrics cover a range of areas, including customer service, employee engagement, diversity and inclusion, health and safety, environmental impact, and human capital management. When used, they typically appear in short-term incentives and often have a relatively small weighting.

As companies deliberate whether and how best to add ESG metrics to executive incentives, questions to consider include the following:

- **Which ESG metrics are most important to driving strategy?** Consider how this focus is changing in light of current events and how these metrics align with published sustainability reports.
- **Which areas of focus are quantifiable or measurable?** If a measure is important enough to your business, it will likely already be focused on, measured, and reported.
- **What standards should be considered for goal-setting?** Examine external standards relevant to your industry and strategy to inform goal-setting and what goals your strategy dictates.

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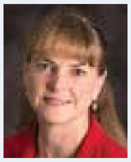
- **How have metrics been tracking over time?** Benchmark key metrics to track progress, and determine that management understands what levers to pull in order to reach key milestones.
- **What is the appropriate time horizon for reaching goals?** Assess whether meaningful progress can be made within a year or if multiple years are required to see improvement.
- **Are there potential unintended consequences to adding ESG metrics?** Think about the ways in which a shift in focus might require a sacrifice in other, perhaps financial, areas. Understand the external messaging of selecting one metric over another.
- **What has already been communicated publicly?** Take stock of the ESG-related goals already shared with investors and the time frame cited for achieving those goals.

It's impossible to pay executives for every item you want them to focus on. The key is to select the few critical metrics that meet the criteria of being measurable, predictable, able to be influenced by management, important to the strategy, and aligned with long-term shareholder returns. If there are ESG measures that meet some, but not all, of these criteria, enhanced disclosure on corporate actions, priorities, and progress may be sufficient to demonstrate to investors and external stakeholders the company's ESG focus.

The COVID-19 pandemic and recent social unrest have brought many ESG issues to the forefront, including employee safety, diversity, and community support. With business priorities currently shifting, companies may experience pressure to incorporate nonfinancial ESG measures into incentives. However, there are ways to sharpen the organization's focus—for example, setting and communicating goals, highlighting existing practices, or enhancing disclosure—without necessarily adding measures to incentives.

By thinking through the questions outlined here, boards will know when (and if) it's the right time to add ESG metrics to incentive plans.



Annette Leckie is a partner at the executive compensation consulting firm Meridian Compensation Partners.