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ESG

Should Banks Tie ESG to Incentive Plans?

Investors continue to increase their focus on environmental, social and governance (ESG) matters, asking how companies will reduce their carbon footprint, increase energy from renewable sources and enhance talent diversity.

Companies are being called upon to discuss how they approach ESG matters relevant to their business. The logical next question is whether, and how, to tie ESG to executive incentives. This is an evolving topic with no simple or single answer. Meridian is conducting an ongoing study of S&P 500 companies' disclosures related to the use of ESG metrics in incentive programs. Our general industry findings based on 2021 proxy filings indicate that 58% of large companies include ESG metrics in annual incentive plans. Of those that do:

- 95% use metrics related to social priorities, and 39% use metrics related to environmental priorities.
- Very few companies employ governance-related metrics. These priorities are often focused on the board, such as board diversity, or are viewed as inappropriate to reward through compensation, like ethics.
- Of companies that use social metrics, 60% include diversity, equity and inclusion (DEI), followed by workforce health and safety (45%), product safety, quality and brand (38%) and human capital and culture/labor (34%).
- Most companies (66%) incorporated ESG within qualitative, discretionary, or individual performance components, rather than as a weighted component. Those that weight ESG metrics generally gave them a small weighting between 10% and 25%.

Only 5% of the studied companies include ESG metrics in long-term incentive plans, which likely reflects the formulaic nature of LTI metrics, challenges associated with developing quantitative metrics and the fact that companies are still in the learning phase of defining ESG metrics and goals. The prevalence and inclusion of ESG metrics in incentive plans may increase as companies become more comfortable defining and measuring their ESG priorities.

Banking Considerations

Meridian is also monitoring practices across the banking industry. Not surprisingly, the largest banks are the earliest adopters as they face the greatest scrutiny from investors and external observers. The majority of the largest banks incorporate ESG as part of their annual incentive plans.

Banks that have added ESG into their incentive plans typically do so as part of the qualitative components of their annual plan. For banks with fully discretionary incentive plans, ESG is one of many factors considered as part of the incentive determination. Other banks incorporate ESG into subjective components focused on strategic or individual performance. By including ESG within qualitative components, banks can exercise judgment in evaluating the progress made on key ESG objectives.

DEI is the most common ESG factor found in bank incentive plans, with progress on diversity objectives considered as a factor in the committee's decision on incentive payouts. In our experience, banks typically evaluate progress across multiple priorities, such as increasing diverse representation, including diverse candidates as part of recruitment processes, and implementing internal inclusion and talent development initiatives.

Outside of diversity, other ESG priorities used by banks in annual incentive plans include community support initiatives, ESG strategy development, human capital initiatives and employee engagement.

Checklist of Considerations

Before ESG metrics are added to incentive plans, it is important to have answers to the following questions:

- Which ESG metrics are most important to the bank's strategic objectives?
- What ESG goals have already been disclosed internally and externally with stakeholders?
- Are the banks' management and board prepared to talk the talk and walk the walk?
- Do you have the systems or procedures in place to measure ESG metrics, and track performance and improvement?
- If ESG is part of publicly disclosed incentive plans, is the bank prepared to disclose the goals and whether or not they have been met?
- If ESG is included in incentives, should it be a formulaic and weighted metric, part of a broader qualitative assessment, or a modifier to adjust payouts?

Shareholder focus on ESG will continue to increase, and banks should be prepared to discuss how they intend to embrace these initiatives. While prevalence of ESG considerations and metrics in incentive plans will likely grow, banks should be prepared to answer the questions above before tying compensation to these priorities.

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As seen in the 4th Quarter 2021 issue of *Bank Director*