COMPENSATION DESIGN

Research Shows How Companies Are Using ESG Metrics in Incentive Pay

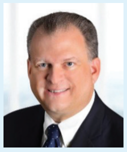
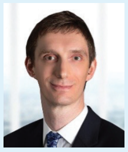
By Donald Kalfen and Nathan Williams

In recent years, companies have become increasingly focused on addressing environmental, social, and governance (ESG) issues, with shareholders, proxy advisors, politicians, and others calling for businesses to include ESG matters in their business strategies. Until recently, it was uncertain how quickly, and to what degree, this increased focus on ESG would be reflected in executive compensation plans. What has become clear is that large public companies have steadily increased the use of ESG metrics in their annual incentive plans.

APPROXIMATELY 60 PERCENT OF COMPANIES INCLUDED AT LEAST ONE ESG METRIC IN THEIR ANNUAL INCENTIVE PLANS.

Meridian's 2021 *Study of ESG Metrics in Incentive Plans* provides current information and data on the prevalence of ESG metrics used in the incentive plans of 315 large US public companies, each of which was listed in the S&P 500 as of Dec. 31, 2020. The following are the key findings of our study:

- **Approximately 60 percent of companies included at least one ESG metric in their annual incentive plans (AIPs).** On the other hand, only 5 percent of the companies included at least one ESG metric in their long-term incentive (LTI) plans. Businesses may be reluctant to include ESG metrics in long-term incentive plans due to the challenge of setting multiyear ESG goals, especially during periods of economic turbulence.
- **The most common ESG metrics used in AIPs were social in nature (96%), followed by environmental (38%) and governance-related metrics (10%).** The prevalence of social metrics is not surprising. Social metrics cover a wide array of highly visible items, such as diversity and product safety and quality, that have universal public company applications. Relatively new social metrics are those related to human capital. We expect the prevalence of human capital metrics to increase over time due to significant shareholder and stakeholder interest and the recent US Securities and Exchange Commission 10-K filing requirement to disclose human capital management matters.
- **Of those companies including a social metric in their annual incentive plans, over 60 percent included diversity, equity, and inclusion (DE&I) metrics.** DE&I metrics are often focused on improving racial, ethnic, or gender representation, but most organizations' DE&I metrics did not include quantitative goals.
- **Unlike the use of social metrics in AIPs, which was widespread across all industries, the use of environmental metrics in AIPs was heavily concentrated.** Energy, utilities, materials, capital goods, and real estate represent 61 percent of environmental-metric users. However, we expect that over time most public companies will come to evaluate how their operations affect the environment, which may increase the prevalence of environmental-related metrics in AIPs across a more diverse array of industries. Regardless of industry, of those companies that included an environmental metric in their AIPs, 54 percent included carbon and climate metrics. The most commonly used carbon and climate metrics were greenhouse gas emissions (37 percent of companies using environmental metrics in their AIPs generally), carbon footprint (24%), and emissions containment (18%).
- **Approximately two-thirds of companies did not disclose any assigned weight for ESG metrics included in their AIPs.** These ESG metrics were frequently listed among other unweighted individual performance objectives (with total individual performance objectives generally weighted between 10 percent and 30 percent). Approximately one-third of companies disclosed an assigned weight for an ESG metric used to determine annual incentive payouts (the most prevalent assigned weights were 10 percent and 20 percent). A small but growing minority of companies (12 percent of those using ESG metrics) used ESG metrics as a performance modifier.

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