ESG & INCENTIVE PLANS

What to think about when weighing incorporation of ESG metrics as a component of incentive pay.

RECENT YEARS HAVE SEEN a sharpening of focus on ESG, with key stakeholders growing increasingly vocal about the import of environmental, social and governance matters. Institutional investors and proxy advisors are pressing companies to enhance disclosure of ESG measures they view as linked to long-term performance, even as employees and customers call on the businesses they work for and buy from to step up on social issues like climate change. The Business Roundtable underscored this shift by revising its principles of corporate governance to embrace corporate stewardship, and regulators, too, are joining the fray, as evidenced by the SEC's recent announcement of new requirements for disclosing material human capital metrics.

The events of 2020 have only served to fuel those conversations, with Covid-19 raising concerns around health and safety practices and social injustice incidents bringing diversity practices front and center. The cumulative effect is a growing alignment of stakeholders around the need for strong ESG practices and the question of what that means for compensation planning, says Erin Bass-Goldberg, managing director at FW Cook. "More and more companies are having the discussion, 'Should we be including ESG in our incentive plans to underscore their importance, to reinforce our commitment to them and to hold our management teams accountable for making progress in ESG areas?'"

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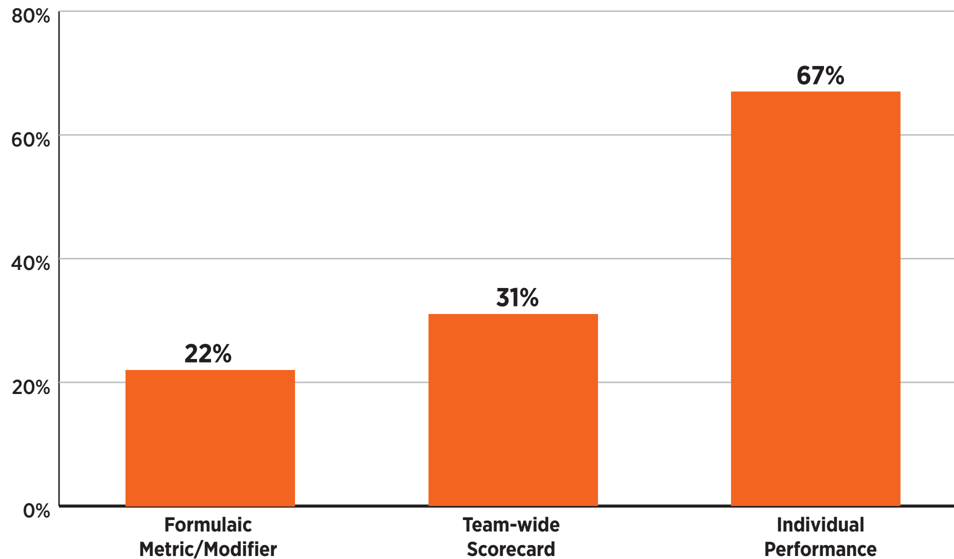
It's a question that merits careful thought. Incorporating ESG metrics into incentive pay practices is a process rife with hurdles, from potential unintended consequences to challenges regarding goal setting and measurement, disclosure and proxy advisor reaction. Companies that move too quickly may set the bar too high—and risk setting themselves up to miss targets and earn stakeholder ire. "This is an area where we encourage companies

ESG Incentive Plan Stepping Stones

Where you are	What to think about	Example
Defining focus areas	Identifying ESG areas that are expected to contribute to long-term sustainable value creation	Diversity and inclusion
Setting goals or objectives	Evaluating whether the requisite processes/infrastructure is in place to set outcome-based goals. If not, build out processes that feed into outcomes over time Setting outcome-based goals without the appropriate processes in place may contribute to poor decision-making	Diverse representation within talent pipeline and succession plan A recruiting plan to identify and slate diverse candidates Appropriate expatriate, developmental and training opportunities available to diverse talent throughout the organization
Considering soft launch	Including measurable goals, with discretion to evaluate results	Diversity goals incorporated into performance rating for merit increase (i.e., not directly tied to incentive outcomes), and/or Diversity goals incorporated into individual KPIs or corporate non-financial strategic scorecard (i.e., considered in determining incentive outcomes in non-formulaic way)
Incorporating into incentives as weighted component or modifier	Setting disclosable quantitative goals that directly and formulaically tie achievement to incentive outcome	10 percent of bonus payout tied to achievement of increasing diverse representation among VPs and above to 20 percent or more

How ESG Measures Are Used in Incentive Plans

(prevalence of types of measures among companies using ESG measures)



Note: Prevalence sums to greater than 100 percent because some companies incorporate ESG into incentive plans in more than one way (e.g., use one measure formulaically and another as part of an individual performance assessment)

to walk before they run," says Bass-Goldberg. "On the surface, ESG measures may seem simple to include, but these are complicated decisions once you start looking at defining your top goals and figuring out how they're measured."

Still, many large companies have already embarked on the journey of adopting ESG measures in their pay practices. A recent FW Cook study, *Use of Environmental, Social, and Governance Measures in Incentive Plans*, looked at all U.S.-listed companies with market capitalizations in excess of $25 billion and found that 56 percent used one or more ESG measures in their annual or long-term incentive plans. However, among those companies, only 22 percent incorporated the measures into formulaic components of their plans. "As far as we can tell, the others used the ESG measures as part of discretionary assessments of individual performance or possibly within a scorecard to measure the performance of the full team," explains Bass-Goldberg, who coauthored a report on the findings. "Rather than disclose, 'We moved our diverse representation from X percent to Y percent,' they may say something like, 'We improved diverse representation.'"

Size and industry play a large role in where companies fall along the journey of incorporating ESG factors in incentive plans. Large companies in industries where a link between ESG initiatives and business strategy is well established are more likely to have quantifiable targets and transparent disclosure of performance against them. "These are the companies that have defined their ESG strategy, how ESG contributes to sustainable value creation and how their ESG objectives should be measured," says Bass-Goldberg. "You can't lead change by including ESG in your incentive plan. It needs to be supporting a strategy."

At Verizon, for example, diversity and sustainability targets call for 50 percent of its U.S. workforce to be comprised of minority and female employees, at least $5.2 billion of its overall supplier spending go toward minority- and female-owned firms and a carbon intensity reduction of least 10 percent. The company discloses the specific weighting for achieving these metrics (a combined 5 percent), an explanation for why these metrics are used and how it performed relative to those targets.

"The way Verizon has incorporated ESG into its incentive plans communicates that this has been a focal point," explains Thomas Kohn, an FW Cook consultant, who says a surge in ESG-related disclosures is likely this year, propelled partly by companies seeking to reward performance in a year when financial goals set in early 2020 have been rendered obsolete by the pandemic. "Where 2020 bonus plans are underwater because financial goals won't hit threshold, companies may consider a variety of non-financial strategic factors, including ESG factors such as employee health and safety, to help them determine whether some level of payout is justified for the year."

For some companies that incorporated ESG metrics in response to Covid-19, the metrics may be temporary—and possibly should be, given the challenges and potential pitfalls of incorporating ESG measures into incentive plan payouts too quickly. However, the events of 2020 also serve as reminders of the rationale driving companies to work toward addressing ESG issues on a lasting basis, says Kohn, citing the fallout of Covid-19 and incidents of social unrest as evidence that ESG factors can trigger financial and operational risk.

"I think we'll definitely see a spike in disclosure of ESG measures in 2021, and it will be interesting to see how many companies keep those the following year," says Bass-Goldberg, who anticipates momentum continuing to build as companies grow more sophisticated with evaluation of key ESG issues. "Over time, we expect more companies to begin incorporating ESG measures into incentive plans more formulaically with greater disclosure of targets and performance."

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