COMPENSATION

TO INCENT OR NOT TO INCENT

What the rising emphasis on ESG means for compensation planning.

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ENVIRONMENTAL, SOCIAL AND governance (ESG) factors have long been on corporate America's radar, but recent years brought a dramatic shift in the way key stakeholders view corporate stewardship. Investors, customers, employees, suppliers and communities have come into alignment around the concept that a strong ESG proposition is more than good citizenship—it is essential to a company's long-term success.

Increasingly vocal about ESG's potential to impact performance, large institutional investors like State Street, Vanguard and BlackRock are pushing companies and their boards to give it deeper consideration. BlackRock CEO Larry Fink's 2018 annual letter to CEOs made headlines with the declaration, "A company's ability to manage environmental, social and governance matters demonstrates the leadership and good governance that is so essential to sustainable growth, which is why we are increasingly integrating these issues into our investment process."

Heading into 2020, that sentiment is now widely accepted. The country's leading proxy firms, ISS and Glass Lewis, have already marshalled their voting clout to call for more disclosures on ESG issues and—in the case of Glass Lewis—even rate companies on their ESG stewardship.

AN IMPACT ON INCENTIVES

As investors' understanding of ESG grows more sophisticated and more robust valuations of key ESG issues become possible, some companies are beginning to incorporate ESG criteria into compensation plans. Currently, only about 30 percent of large companies include some kind of sustainability metric in their incentive plans—but the number is likely to increase. "When things are deemed to be important, they have a tendency to work their way into incentive plans," says Dan Ryterband, CEO of FW Cook, who urges companies considering adopting ESG metrics to proceed with caution. "It's really critical to be careful about how it's embraced in a compensation system because there is potential for unintended consequences."

Moving too swiftly to incorporate sustainability metrics into incentive plans can backfire. Quantifiable ESG metrics are also not easy to develop, which makes goal setting challenging—and missed goalposts potentially more problematic.

"For example, failing to meet a carbon emissions target or a diversity goal is not as easily explained in proxy statements as missing a profit target," says Ryterband. "When you miss on one of these important ESG issues, it could imply poor leadership or worse—and companies want to avoid being in a position where pressure to achieve the goals on a short-term basis drives decisions that may not be best over the long term."

There's also the possibility that efforts to incorporate ESG-related metrics in bonus opportunities will be interpreted as signifying how much, exactly, a specific concern matters to a company. "Compensation planning is one of those areas where sometimes the more you try to do right, the more you might be punished," says Ryterband. "You may be thinking, 'We added this metric because we think it's important,' but because it is part of a multi-dimensional 'balanced scorecard' and, therefore, affects only a small portion of the total bonus opportunity, it might actually be interpreted by employees and investors as being unimportant." Ryterband adds that "inclusion of some ESG metrics also raises questions about the exclusion of others."

Even tougher to navigate is the fact that different stakeholders tend to have different perspectives on both the relative importance of various ESG issues and how best to evaluate a company's efforts. Public employee retirement plans, for example, may have a very different ESG investment thesis than investors like Vanguard or BlackRock—and both groups' view may differ significantly from the priorities of employees, suppliers or the community in which a company operates.

Gathering all of these perspectives and reconciling them is one of the early hurdles of incorporating ESG metrics into incentive pay practices. "The first issue is that you really need to understand what your investors care most about and why—which requires substantial investment of time and resources," notes Ryterband. "You don't get that information by sending out an Internet survey; you have to sit down, investor by investor, to dialogue on the issue."

PICKING PRIORITIES

Where companies stand on adopting this level of ESG assessment effort tends to vary by company size and industry, adds Alexa Kierzkowski, a managing director at FW Cook. Larger companies with high public visibility are more likely to have or be exploring ESG metrics, with some even going so far as to hire a sustainability expert charged with evaluating issues and engaging with investors to help the company form positions on ESG issues. "For example, we often see environmental concerns as a priority at companies in industries that are clearly and directly tied to the environment—energy companies, mining companies," says Kierzkowski. "Many of them already have some kind of environmental goals, whereas, in other sectors, it's much more nascent with boardroom conversations just beginning."

In those conversations, management and the board must vet investors' and other stakeholders' priorities against their strategic vision for the company. "The next question is, among the items they care about, what do you believe is truly a value driver for the organization?" says Ryterband. "Applying resources to maximize your scores and improve on the metrics investors may believe are most important may not actually deliver on the organization's value proposition."

Even then, they may be worth considering in today's business climate, particularly in the wake of the Business Roundtable's recent declaration revising its principles of corporate governance to include a new statement of corporate purpose. Supported by nearly 200 of its CEO members, the statement signified a fundamental philosophical shift that is raising questions for many business leaders.

"One might argue that this change is simply an articulation of what companies have already been doing," says Ryterband. "But it is a major change with significant implications for corporate governance. It might actually lead a company to say that they are going to make investments in certain ESG areas that don't bring immediate benefits to shareholders because doing things that benefit other stakeholders—society as a whole, employees, the community, the environment—drives longer-term value creation that may not be something you can measure. You just know it's right. You feel it and, therefore, you do it, and the true test will be performance over time."

On a more pragmatic note, companies also face the very real possibility that the mounting pressure from stakeholders and society as a whole is likely to lead to legislative and regulatory implications—something already under way in other markets. In the UK, for example, the Financial Reporting Council recently adopted a voluntary code that "establishes a clear benchmark for stewardship as the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society."

"While it's voluntary, the important point is that those who don't adopt the standards will be required to disclose why," says Ryterband. "All of this is obviously going to put a lot of pressure on listed companies to publish their ESG initiatives to enable asset managers to evaluate them."

Clearly, the forces driving companies to address ESG issues and report on their efforts are formidable and unlikely to fade. However, given the potential pitfalls, companies would do well to exercise caution as they weigh moving toward incorporating ESG goals directly into executive compensation incentive structures. In some cases this makes sense, but Kierzkowski also notes that "companies can make ESG issues a corporate priority, particularly if supported and encouraged by directors, without necessarily including specific elements in incentive plans because performance on these issues will reflect in overall results on both a short- and long-term basis."

"The key message is to think about these things carefully before you jump all-in, because once you've made these changes to your compensation system, you're going to be measured on them by investors and others," says Ryterband, who points out that any incentive targets put in place will be difficult to unravel. "If the metrics were truly deemed important, and you conclude you're going to take them out, that will imply that you decided they were not important after all—which will require some explaining."

"The bottom line is that once a company has an understanding of what their investors care about, they then need to review all of that to determine whether or not, based on their own model, it drives sustainable value creation. Then, once that's done, they have to determine how to best measure it and manage those issues. Inclusion in the compensation plan may not be the only—or the best—way of doing that."

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>
> **—Dan Ryterband, CEO, FW Cook**

Alexa Kierzkowski is a managing director at FW Cook with extensive experience in total compensation reviews, ongoing program management, corporate transactions, director compensation, short- and long-term incentive design and pay-for-performance assessment.

Daniel Ryterband, CEO of FW Cook, consults to organizations on all aspects of executive compensation strategy and design, including the related tax, accounting and securities law implications, as well as matters of corporate governance and investor relations.