THEME ARTICLE

Driving Environmental Stewardship through Executive Compensation

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The Intergovernmental Panel on Climate Change's (IPCC) 6th Assessment Report released in August this year callout climate change as a code red for humanity. Unless the world sees a drastic reduction in greenhouse gas (GHG) emissions well beyond the targets already adopted worldwide, average global temperature is expected to surpass the 1.5^{o}C threshold within the next 20 years, causing extreme and irreversible damage to people and the planet. South Asia, including India, will experience an increase in extreme weather events.

Given the criticality of climate crisis, more and more companies and investors are realising the importance of including climate change metrics both in management systems, corporate disclosures, and compensation plans alike. Additionally, other stakeholders including customers and employees have joined the discussion and are voting on their feet and favouring companies that take climate change seriously. Customers are also more willing to buy products and services that set meaningful targets for climate change.

India's recent announcement of a net-zero target at the COP26 Summit is a signal of its climate action and steps the country is taking to curb carbon emissions. However, to translate this target into reality, laying out a pathway to reduce emissions and transition to a low carbon economy is going to be the next step.

Executive compensation as a change accelerant

Executive compensation – both as a carrot and a stick – is a critical lever for companies' management to be held accountable for climate transition. Incentive plans have proven to be an effective tool to focus management's efforts on key priorities and drive desired outcomes. As the saying goes, 'what gets rewarded gets measured, and in turn, gets done'.

In 2019, the World Economic Forum unveiled the Principles for Effective Climate Governance for non-executive board directors. These principles set out how well-governed boards should incorporate a climate lens into all relevant aspects of their oversight functions. In particular Principle 6 — Incentivisation, identifies executive compensation as one of the key mechanisms that drive the right behaviours and enable the company to deliver on its climate transition strategy.

Board Remuneration Committees view Climate and other Environmental, Social and Governance (ESG) issues as top business priorities. They are incorporating these goals in performance management and executive incentive plans.

According to Willis Towers Watson's 2020 board of directors' global survey on Aligning ESG and Executive Incentives, nearly four in five respondents (78%) are planning to change how they use ESG with their executive incentive plans over the next three years. Directors listed Environmental and Climate issues as their number one priority, and 41% plan to introduce ESG measures into their long-term incentive plans over the next three years, while 37% plan to introduce ESG measures into their annual incentive plans.

Metrics that matter: measuring carbon emissions

Depending on the industry, there could be several Climate related goals - such as GHG emissions, Carbon intensity, water security, waste management, circular economy, bio-diversity, renewable energy consumption etc. However, the most pressing goal is related to GHG emission reductions.

Tonnes of carbon-dioxide equivalent (tCO_2e) is the most commonly used and standardised unit in carbon accounting to quantify GHG emissions. tCO_2e is the unit for GHG emissions, reductions, carbon pricing, and carbon credits. It is an important agreement in climate change policy as it provides a standard measure of emissions. The six main greenhouse gases: carbon

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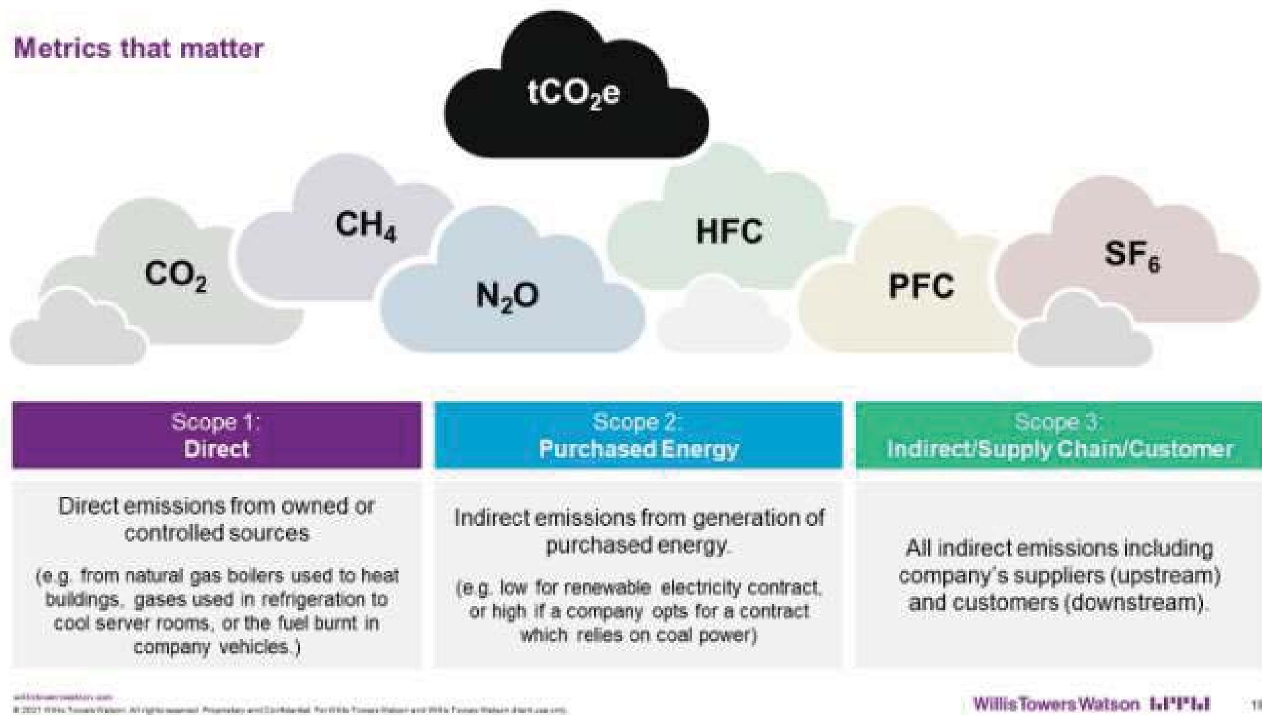
dioxide (CO2), methane (CH4), nitrous oxide (N2O), hydrofluorocarbons (HFCs), perfluorocarbons (PFCs) and sulphur hexafluoride (SF6) are converted according to their global warming impact and expressed as tCO2e.

A company's GHG emissions can be classified under three scopes. Scope 1 is direct emissions from owned and controlled resources, Scope 2 is indirect emissions from sources of purchased electricity and Scope 3 is all indirect emissions along the company's value chain, including suppliers, customers, and partners.



To effect meaningful change, companies should set sufficiently stretched and long-term tCO2e reduction targets. For example: a 50% reduction by 2030 and net-zero by 2050. In some industries environmental impacts are at the core of their business strategies and companies are transforming their portfolio or product mix accordingly. Not only do they need to focus on both climate impact measures such as CO2 emission reductions, but also on climate transition priorities, such as energy companies shifting towards renewable energy production.

Incorporating climate measures into incentive plans

There is a strong consensus among investors that companies must select climate metrics that are material to their businesses. Investors expect companies to demonstrate the appropriateness and extent of climate metrics through market-leading disclosure. They want the metrics to be material to the company and goals to be significant, measurable and transparent. If sustainability and environmental goals are front and center of the company's business strategy, then it should consider linking relevant ESG measures to executive incentive plans.

There are a few design alternatives to do so, ranging from underpins, to modifiers, to short-term incentive (STI) plans, to key performance indicators (KPIs) within long-term incentive (LTI) plans, and a standalone hyper-long-term incentive plan.

Whilst over the past few years, we have seen an increase in prevalence of ESG metrics in executive incentives, there is still room for improvement for adoption of climate metrics. Based on a recent Willis Towers Watson's research of US S&P 500 companies and top 350 European companies, more companies have environmental measures in their annual incentive plans compared to their long-term incentive plans. And we expect more companies to start incorporating ESG and Climate measures in both STI and particularly in LTI plans.

Indeed, most boards believe that climate goals should be measured over the medium- to long-term (three to five or more years), even if this means incentivising executives to make longer-term climate investments that often do not bear fruit during their tenure.

Effective governance of climate-related compensation plans

The continuum of effective compensation governance starts with the company's business imperatives. And the Board plays a critical role in setting the long-term vision and defining short- and medium-term milestones. Boards need to prioritise which climate topics are most important to address, where they should be addressed (i.e which committee or the full board), how often to address them and how to provide effective oversight.

Following which, the Remuneration Committee and the Board should pay attention to the selection of relevant performance measures. This should start with a broad funnel of metrics and then refined based on key principles of alignment with strategy, materiality of outcomes, measurability and target-setting, comparability over time and across companies, and clarity and transparency. Metrics that are consistently measured and tested by management, reviewed and vetted by the board, and shown to be material to the business and of value to investors and stakeholders, should then be linked to incentive plans as discussed in earlier section.

Next, companies should pay heed to disclosures to investors and the public. It is important for management and the board to be in sync on what gets disclosed and how it gets communicated. The board should review and discuss the programs and achievements summarised in public statements. Finally, the Remuneration Committee and the Board must monitor progress and direct management to expand, contract or reprioritise the range and depth of climate issues management is taking on.

Call to action for companies

The merits of linking executive compensation and climate objectives are well established. Emissions reduction and renewable energy adoption are increasingly prevalent metrics in executive incentive plans, especially in Europe and the U.K. and in high-emitting industries such as Oil and Gas.

There remains much for the business community to learn about the implications of transition to net-zero. Setting consistent and reliable goals and milestones will be challenging. But companies must resist the temptation to inaction, as climate risk is widely considered the single most significant risk to the planet, businesses and the stability of the global financial system.

The recently released 'Executive Compensation Guidebook for Climate Transition' by Willis Towers Watson in collaboration with the World Economic Forum's Climate Governance Initiative provides an important resource guide to companies. As companies navigate through some of these complexities, they will benefit from drawing on key executive compensation guiding principles of *Purpose, Alignment, Accountability, and Engagement*.

Importantly, this starts with the appreciation of why the organisation exists, ensuring management is aligned with interests of all stakeholders, having clarity regarding pay and performance linkages, and understanding human behaviours, retention and engagement. These will help companies design more meaningful pay programmes and effect positive outcomes.

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