Paying for Sustainable Performance

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Environmental, Social and Governance (ESG) concerns have risen rapidly to the forefront of board awareness in recent years. No sector or business is left unaffected by societal demands for a more sustainable and robustly governed way of doing business that reflects planetary and social boundaries.

As Late Lt. Gen. J. S. Ahluwalia, President of the Institute of Directors, highlighted in the January 2022 issue of Director Today: *"In the evolving ESG landscape in India, corporates need to prepare their own road maps for best-in-class approaches and practices for ESG governance and integration."*

One area of ESG governance where practice is evolving rapidly is the remuneration of executives and senior leaders within companies. The line of argument is straightforward: we want more ESG, we get what we pay for, and therefore, we need to include ESG targets in executive incentive plans. In practice, it is not always so simple, as we shall see. But the result has been rapid growth in the proportion of companies using such targets.

A recent study by PwC and the Leadership Institute at London Business School- *'Paying for good for all'*, demonstrated the extent to which ESG targets have become prevalent in pay plans around the world. In a survey of over 600 senior leaders globally, we found that 77% already have ESG targets in their incentives, increasing to over 90% in India. In most cases

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this was in the annual bonus, although around half of senior leaders globally say they now have ESG targets in their long-term incentive plan (LTIP). The typical weighting amongst companies that have such targets is currently 10% to 15% of the incentive, which senior leaders think is about right. But investors want to push it higher, to between 15% and 20% on average. This is one area where Indian practice appeared to be ahead of the market, with senior leaders reporting a median 16-20% of incentives linked to ESG factors where their pay included such targets.

The enthusiasm for linking pay to ESG is widespread. Two-thirds of investors and around 90% of senior leaders support the practice of linking pay to ESG. Although senior leaders, perhaps more aware of some of the pitfalls in the practice, were somewhat circumspect: of those supporting the practice, 40% said that pay should only be linked to ESG targets in the minority of companies facing the most material ESG issues.

Contradicting some common prejudices, our study found that listed companies and firms backed by private equity are the most likely to include ESG targets in pay, although partnerships and owner-managed and family-run businesses were not far behind.

So the momentum towards linking pay to ESG seems universal and unstoppable, but the question remains how to do it well. Our study explores what investors and senior leaders hope to achieve by linking pay to ESG, how they go about it in practice, the risks and difficulties to be managed, and how to create the link in an effective and sustainable way.

Creating focus on the right things

Investors and senior leaders agree on the motivations for linking pay to ESG:

	Investors: Somewhat to strongly agree that having ESG in pay can-	Senior leaders: Having ESG in pay helps somewhat to a great deal to-
Help focus on non-financial factors that drive long-term shareholder value.	86%	86%
Signal to employees and external stakeholders the importance of ESG factors.	86%	87%
Force companies to set shorter term targets towards their ESG aspirations	85%	85%

First, on the whole investors and senior leaders believe that a focus on the right ESG factors supports long-term shareholder value creation; in India, 90% of senior leaders agreed with this. But investments in ESG can conflict with profit maximisation in the short term. Incorporating ESG targets into pay can therefore help ensure appropriate focus on non-financial factors that drive long-term shareholder value.

Second, the role of pay in signalling intent is important. Organisations use pay to communicate priorities to managers and employees. Particularly if the focus on ESG is new or evolving, including it in pay is a way of grabbing the organisation's attention. Many participants in our study reported that the focus on ESG is being supercharged by younger generations, who are proactively asking their employers (and prospective employers) what they are doing in the area. Linking pay to ESG – "putting your money where your mouth is" – can be a powerful way of signalling intent to stakeholders inside and outside the company.

Third, many organisations are committing to long-term ESG goals, particularly net-zero goals in the battle against climate change. The process of setting pay targets imposes a discipline to translate these longer-term aspirations into tangible short-term goals over one to three years. AllianzGI and Cevian Capital are two major investors who have publicly supported this view, stating that "The inclusion of climate metrics into remuneration requires a strategic discussion between board & management, which will be valuable in itself, as it forces companies to determine their immediate priorities." *(Ahead of the curve: tie executive pay to climate targets, Investment & Pensions Europe, June 2022 issue)*

What to target?

Differences in view between investors and senior leaders emerge when considering what ESG targets to focus on. Most senior leaders prioritise factors relating to employees: health & safety and employee satisfaction. This was even more pronounced in the Indian market, with around two-thirds of Indian senior leaders supporting a focus on the direct value drivers of employee satisfaction, health & safety, and risk. By contrast investors focus on decarbonisation and environmental goals. *(See Figure -1)*

In part this reflects different perspectives. Senior leaders are focussed on maximising value in their company and employees are a group of stakeholders that is intimately linked to value creation. For many companies, environmental impact may not be the most material ESG factor. By contrast, investors managing highly diversified portfolios have a greater concern for so-called "systemic risks" across the market and are coming under pressure from asset owner clients to take action, particularly on the environment.

But this difference of view does highlight one challenge with linking pay to ESG. For example, given their concerns about climate change and the impact on their portfolio more broadly, investors may push a heavy emitter to decarbonise quicker than is economically optimal for that specific company because this reflects the investor's wider preferences. This creates tension

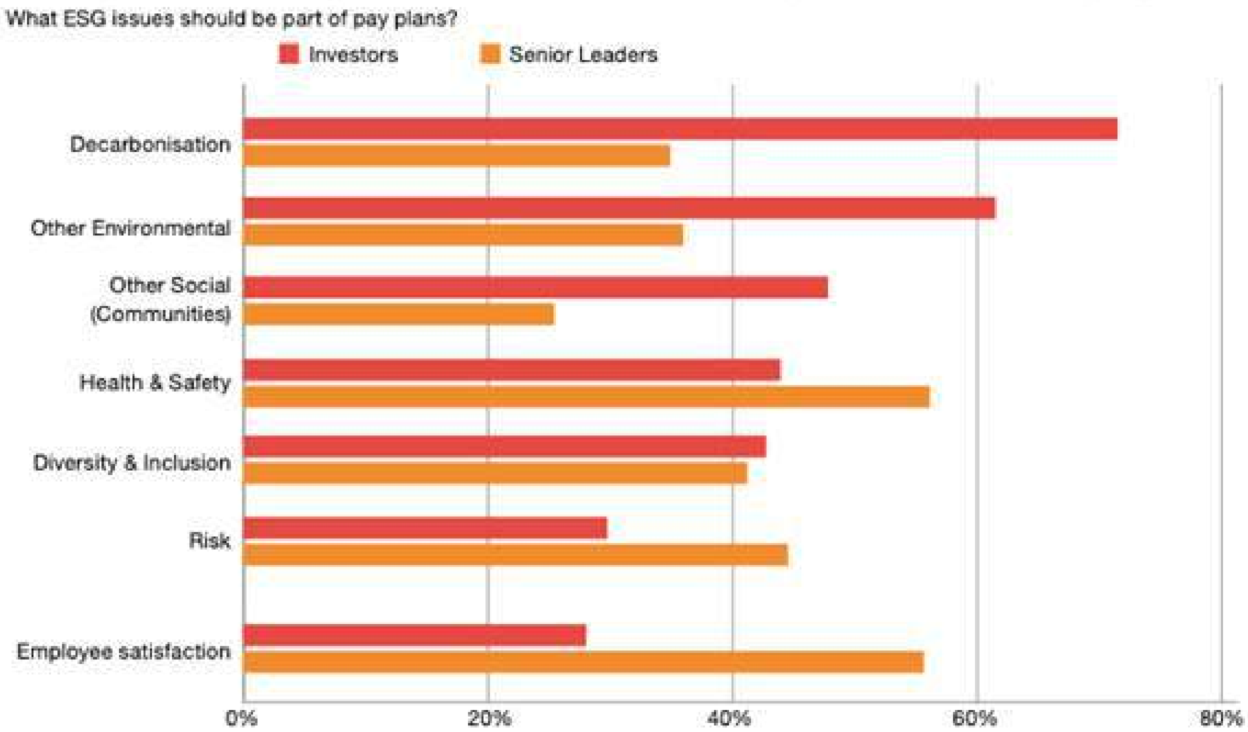

Figure -1

between the fiduciary duties of the company directors and of fund managers, which can only be reconciled through very clear communication, engagement, and in the case of investors, explicit client mandates.

Boards selecting ESG measures to include in pay need to resist the temptation to throw everything into the mix. Companies are expected to pursue many important goals that are not normally included in pay, such as innovation, new market strategies, managing cyber risks. So not everything that is important should be included in incentives. Excessive complexity of pay was encountered as a challenge by 43% of executives using ESG targets. And there are other mechanisms, through transparent communication and reporting for example, that create accountability relating to a company's ESG goals. Therefore, boards should select only the most material ESG issues for inclusion in pay, in order to avoid excessive complexity.

Risks and challenges

As investors, regulators, and policy makers increasingly reach for the lever of linking pay to ESG targets, it is important to recognise the risks of adopting this approach. Indeed some prominent academics believe that it is misguided to try to link executive pay to ESG targets. *(Such as Alex Edmans in "Why Companies Shouldn't Tie CEO Pay to ESG Metrics", September 2021, or Lucian Bebchuk and Roberto Tallarita in "The Perils and Questionable Promise of ESG-Based Compensation", March 2022)* There are several risks that need to be managed.

First, ESG targets can be **very difficult to measure** reliably. Amongst Indian senior leaders, 44% identified this as a key risk. There is often disagreement about how a particular ESG dimension should be quantified and disagreement about what an ambitious goal should look like. This can make assurance of targets and outcomes challenging, reducing confidence in the target-setting process.

Second, is the danger of **hitting the target but missing the point**? If a complex ESG goal is reduced to simplistic metrics, then those metrics can be hit without making progress on the underlying goal. For example, targets relating to board diversity can be met in the short-term without making progress on the much more important, but hard to measure, underlying issue of creating an inclusive culture and redesigning work to suit under-represented groups more broadly in the organisation.

Third, putting ESG targets in pay can **distort incentives**. Simplicity and prioritisation demands that only a subset of ESG issues can be reflected in pay. But this can then cause excessive focus on this subset of goals compared with broader stakeholder considerations. Companies have many non-financial goals that need to balance. Putting one or two ESG goals in pay may distort incentives towards this at the expense of competing priorities. This was the top risk for Indian senior leaders, identified by around half of survey respondents from this country.

Fourth, adding ESG targets to pay **may just mean more pay not more ESG**. Most ESG targets set by boards are aligned with activities that companies were intending to do anyway. As non-financial targets tend to be more within control of management than financial targets, they tend to pay out higher on average, as is borne out by the data.

These risks cannot be wished away but need to be actively managed. Measure selection is critical here. We recommend four rules for boards:

1. Focus on the **most material strategic ESG issues requiring a step change in performance**. Focussing on a limited number of key objectives that are clearly strategically aligned maximises the chance that the ESG issue will be measured and calibrated effectively. If a step change in performance is required on the metric, then this also lessens the risk of distorted incentives. Focussing on the clearly most material issues helps to ensure focus and keep the incentive plan simple.
2. Set **sufficiently tough targets**. The credibility of pay linked to ESG targets, and the boards that set them, will be undermined if they are perceived to be to easily achieved. Stretch targets need to go above and beyond what is already baked into base case strategic plans and need to reflect external perspectives on what sufficiently rapid progress entails.
3. Use **transparent and assured measurement** criteria. Given the rapid pace of change and the level of uncertainty relating to ESG issues there is an understandable desire for ESG targets to have a significant degree of qualitative assessment or opacity associated with them. Full prospective transparency, clear definitions and appropriate assurance can build confidence in the measure.
4. Consider **accountability mechanisms**. In certain cases a knowledgeable, resourced, and committed anchor shareholder can create appropriate external accountability for measures. In other cases transparency and engagement with external bodies (e.g. industry diversity initiatives) can help ensure accountability for robust measurement.

Evolving governance

Senior leaders highlighted how governance needs to evolve to address the growing prominence of ESG. At a very practical level, HR and ESG specialists within a company now need to work together in relation to incentive setting in a manner that has not applied before. One Reward Director noted that "there were challenges in working with the sustainability team to determine appropriate targets for a LTIP."

But more broadly, board governance over ESG target setting and assessment needs to be developed. In many companies a sustainability committee will take responsibility for scrutinising, monitoring, and measuring achievement of the ESG strategy and goals. They will need to have an appropriate input into the remuneration committee discussion at key points in the remuneration process, particularly the setting and assessment of targets. The governance needs to be synchronised so that the remuneration committee retains independent oversight of, and ultimate decision making in relation to remuneration, but with appropriate input in relation to ESG from other committees on the board. This is a well-travelled road in, for example, banks in relation to risk and resources companies in relation to health and safety, but in other sectors may be a new development.

It's about culture not pay

Perhaps the strongest message that came out from our interviews with senior leaders was the importance of culture relative to pay. Senior leaders we interviewed in our study were almost unanimously of the view that pay by itself will not drive the right behaviours in relation to ESG. As one director put it: "Having [ESG] run through our culture and DNA is far more important than building into incentives." Having a strong culture relating to integration of ESG into strategy and operations is also a significant safeguard against the risks highlighted above.

A common regret amongst senior leaders was focussing too much on the mechanics of pay plans and not enough on engaging with employees on the ESG strategy and how to incorporate it into pay. Addressing employee concerns about your company's impact on society and the environment is a big part of the business case for including ESG targets in pay: 93% of Indian senior leaders agreed that doing more around ESG

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made their company a more appealing employer. Engaging employees appropriately through the process, rather than taking a top-down approach, is therefore a crucial component of success. The comments of one HR Director were typical of what we heard: “In retrospect, I would engage the business more to determine what the incentive measures should be. I am not sure going top down gets the right result.”

While communication and engagement are a bit part of getting the right culture around ESG, so too are leadership and strategic alignment. Ensuring the CEO is fully on board is vital. And for the ESG strategy be credible and sustainable, employees must understand how it links to the company's strategy to create value.

Doing it well

A common theme across our study was that integrating ESG into the business is about much more than pay. Pay design, and making the right choice of metric, pay vehicle, weighting, and performance scale is important. But as a tool for influencing culture and behaviour it will fail unless placed within a broader context of change and building of the appropriate capability to execute.

Tell the story, linking to strategy. Employees and other stakeholders need to understand how ESG goals link to the company's strategy and priorities. Without this alignment, goals will lack credibility.

Lead with culture, support with pay. It is culture, not pay, that drives sustainable behaviour in support of ESG strategies. Pay must be seen as the enabler of culture, not the sole driver of it.

Engage, communicate, empower. Engaging employees in development of the ESG strategy increases ownership of the goals. Employees need to understand how they can influence ESG goals and must be given the tools and freedom required to do so.

Build capability and collaboration. Integrating ESG into pay requires, at least, close collaboration between HR and sustainability functions – and it might also require new capabilities in both. Governance oversight of target setting and measurement might need to evolve to enable appropriate input from sustainability committees into the remuneration process.

Maintain a focus on value. Good ESG performance can't be an excuse for not creating value. The best organisations capture the symbiosis between ESG and long-term financial performance specific to their company, and pay arrangements need to reflect that.

Through our study we identified five important lessons if pay is to support the integration of ESG strategies into the day-to-day operation of the business.

Underpinning successful linkage of ESG to pay is being clear on why you are doing it. What is the purpose of the ESG strategy, how does it create value, and how does the link to pay support its execution? The world of ESG is populated by special interests with loud voices, which can create an environment of corporate reactivity rather than proactivity. While this cannot be entirely ignored, it is important to retain a strong focus on what you, as a leader in your organisation, are trying to achieve. Ultimately, this is the long-term sustainable success of your business.

There is continuing debate about the extent to which ESG and long-term value are aligned. But what is clear is that it is difficult for a business to be sustainably successful without treating its stakeholders and the environment with respect. And equally so without creating long-term value for its shareholders.

The linkage of ESG to pay must reflect both.

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