Driving ESG Accountability Through Executive Compensation

Description

As companies face increasing pressure from various stakeholders to expand their ESG efforts, the idea of “putting your money where your mouth is” is gaining traction to demonstrate commitment to achieving ESG goals. Increasingly, companies are integrating nonfinancial ESG factors into executive compensation programs as a way to drive accountability toward ESG and respond to the concerns of investors and others.

Objectively designed incentive compensation structures are not new. They have long been seen as integral to driving financial performance and shareholder returns. But incentive programs that target ESG goals are still relatively novel. Thus, when companies initially consider taking this approach, questions often arise around the right way to integrate ESG into the executive compensation structure.

Establishing a Functioning ESG Ecosystem

An effective ESG executive compensation program can succeed only within a robust ESG ecosystem. That ecosystem is grounded in two elements that are under the purview of the board: having a thorough understanding of the ESG risks and opportunities that are most material to the company, and having verifiable systems to track the relevant data and key performance indicators to evaluate the company’s achievement of those ESG goals.

Many boards have spent a significant amount of time evaluating their organizations’ ESG ecosystem as part of drafting sustainability reports, which requires a thorough review of ESG-related risks and the controls that are in place to mitigate those risks. Boards should revisit this work to evaluate whether the company has a sufficiently robust ESG ecosystem and to identify the most relevant ESG metrics for inclusion in the compensation program. This direct linkage between the sustainability report and the metrics selected allows for easier communication of both the rationale for their selection and the rigor of the metrics selected, which is a critical component of the process.

Integrating ESG into a Compensation Plan

Once a board has satisfied itself that it has achieved the requirements related to the ESG ecosystem, the compensation committee can begin to consider integrating ESG into its executive compensation
plan. Compensation committees should assess, at minimum, the questions listed below to successfully integrate ESG into the executive compensation plan.

Where do ESG goals fit in the company’s executive compensation plan? Is the plan part of annual incentive compensation, long-term incentive compensation or both? Boards should take a thoughtful approach toward determining where ESG fits into the executive compensation plan, as no one-size-fits-all approach exists. To date, ESG has most often been integrated into annual incentive plans. This approach is consistent with the view that companies should make annual progress toward their longer-term ESG goals and that investors generally prefer to see the long-term incentive plan based on the achievement of financial results and shareholder returns. On the other hand, companies have often identified long-term ESG goals with the achievement of targets several years in the future. In this sense, integrating ESG into the long-term incentive plan may be a better fit for a company’s ESG strategy.

How should the ESG goals be incorporated into the compensation structure? Should they be included as a discrete percentage of the overall bonus, or should they be a modifier? Compensation committees with incentive plans based on the achievement of financial goals may be inclined to simply keep that structure and add a modifier based upon the evaluation of ESG performance of plus or minus 15%-25%, for example. This determination should also take into account how many ESG metrics to include in the program, again based on the company’s materiality assessment.

- Has the company identified one or two ESG risks or opportunities that are significantly more material than others? If so, the right approach may be to include these goals as either a specified percentage of the overall incentive bonus or as the basis for determining the overall bonus modifier.
- Conversely, if the company has three or more relatively equally material ESG goals, a scorecard approach may make more sense so that the company can evaluate its overall performance against all of these goals.

How should performance against ESG goals be evaluated? Compensation committees may be inclined to evaluate performance qualitatively, as not all ESG goals are strictly quantifiable. If using this approach, the compensation committee should still demonstrate a rigorous assessment and thoughtful rationale behind the evaluation. An alternative is evaluating quantitatively. The primary advantage of such an approach is that it is closer to current best practices for establishing financial objectives in executive compensation structures. It comes with risks, however. If the goals appear too easily achievable, criticism can follow; if set too high, the company may experience reputational risks for not achieving their most material ESG goals.

It’s important for compensation committees to remember that adding ESG goals to the compensation plan is only the first step when integrating ESG into the plan. An equally important next step is disclosing the performance metrics and the actual pay at the end of the year. While there is an emerging consensus across the business landscape that integrating ESG into executive compensation is a critical way to drive accountability, there is no one-size-fits-all approach. Compensation committees would be wise to consider the above questions before attempting to integrate ESG into their executive compensation programs — and then do so only when the time is right, and after engaging with company stakeholders to gain their perspectives.