ESG Measures Are Gaining Prominence in Executive Compensations Plans

By Bill Hayes

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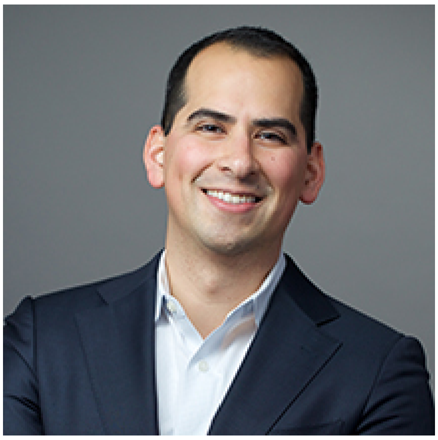
The practice will only grow as disclosure of climate-related data becomes more commonplace.



Brian Bueno

Increasing regulatory pressure as well as stakeholder and shareholder expectations around ESG have thrust sustainability issues directly into the topic of executive pay. Many stakeholders expect their top leaders to be judged on the role they play in lessening the company's negative impact on the environment or strengthening diversity among the workforce. We spoke with Brian Bueno, ESG leader for Farient Advisors LLC, to discuss ESG's growing influence on executive pay, as well as what boards can expect from investors and regulators in the upcoming months.

***Directors & Boards*: How would you describe the current status of ESG's usage in executive pay? Are companies starting to tie compensation of CEOs into sustainability success?**

Brian Bueno: The use of ESG and sustainability considerations in compensation plans, specifically in incentive plans (such as bonuses and performance-based equity), has grown considerably in recent years. In fact, about 58% of S&P 500 companies now use ESG measures in compensation programs.

Additionally, we’re seeing the use of ESG measures become more quantitative with greater use of measures tied to specific and objective goals. For example, when companies use diversity measures to increase representation of women or ethnic minorities in their workforce, we found that, in 2022, a majority of those companies use quantitative measures rather than the qualitative measures a majority had been using in prior years.

The most common types of ESG measures are social and people-related, such as diversity, employee engagement or workplace safety. But one interesting development in the past year has been the significant increase in the use of environmental measures, such as those targeting reductions in greenhouse gas (GHG) emissions. Among large caps with ESG measures, about 46% are now using environmental metrics, which represents a sharp increase from the prior year. As companies and boards become more comfortable with ESG measures and setting goals around them, these metrics are increasingly incorporated into compensation plans.

***DB*: What do you think boards can expect from investors and regulators**

Will they be more involved in

BB: Despite some pushback on ESG from states and some anti-ESG voices in the market, we expect investors to continue their pressure campaigns on companies to adopt sustainability strategies, disclose ESG data, and set long- and short-term goals on climate and workforce diversity.

Looking at Institutional Shareholder Services’ (ISS’s) recently released policy survey for the 2023 season, there is an increased focus on climate and companies' plans for transitioning away from fossil fuels. The survey is an indicator of the policy updates and focus that are coming from ISS and large investors in the upcoming season.

The ISS survey asked participants to weigh in on, among other things, what should be considered a "material governance failure" for significant GHG emitters, justifying a recommendation for shareholders to vote against directors at such companies; whether ISS should extend its policy on climate beyond the Climate 100+ companies; what factors ISS should use to assess the adequacy of a company's climate change transition plan when reviewing "say on climate" proposals; and what investors should reasonably expect from companies in the finance sector on GHG emissions associated with their lending, investment and underwriting portfolios.

From regulators, we have the SEC climate risk and GHG emission disclosure proposal, which we expect will become final in some form later this year. Despite the pushback by some companies, the rules are not that different from, and are partially based on, what many companies now disclose under the Taskforce on Climate-Related Financial Disclosures standard.

From the SEC, we're also awaiting more prescriptive rules on human capital management disclosures, which may mean more standardized disclosures on things like employee retention, turnover and diversity.

***DB*: Has there been a shift in what investors are expecting from companies when it comes to ESG and its status as a factor in executive pay plans?**

BB: We've seen large investors in particular release specific policies on ESG in compensation. For example, BlackRock and Vanguard both released policies for the 2022 proxy season that specify that, while they do not expect or require companies to adopt ESG measures in compensation plans, if companies choose to use ESG metrics in compensation, the measures are expected to be relevant and material to the company, tied to the company's long-term strategy and implemented with rigorous goals.

A more aggressive example is AllianceBernstein, which expects its portfolio companies to tie compensation to ESG measures. And, if they don't, they'll engage with the company. UBS is another example, but they take an industry-specific approach, expecting companies in high-emission sectors like oil and gas to tie climate metrics specifically to incentive programs.

I think we can expect these policies to get more specific as time goes on, and, in certain cases, they will become more aggressive, like AllianceBernstein or UBS.

***DB*: What kinds of criteria are investors using to decide whether a company's ESG pay metrics and goals are effective enough?**

BB: If an ESG measure or goal is being used, investors don't want them to be layups for easy incentive payouts. As such, they want to see if the goals are rigorous and paying for outperformance (so, not what would have happened anyway), and if performance is good or moving in the right direction.

To assess this, investors will look at actual payouts on ESG measures — are they paying out at maximum? Were the goals easy to achieve? Were they too easy? And, in certain cases, we know they are telling their portfolio companies that their metrics aren't mature enough or the goals are not rigorous enough. In these cases, boards often must go back to the drawing board and work with their compensation consultants and sustainability and HR teams to figure out what metrics or goals make more sense moving forward, will be viewed favorably by their investors and drive performance.

Investors are also tracking companies' performance across metrics like their GHG emissions or the gender or ethnic diversity of the workforce. With sustainability reports and disclosure now an expectation, and with many companies disclosing multiple years of ESG data, investors can do year-over-year comparisons to assess whether companies are making progress — both on an absolute basis and relative to their peers or industry.

***DB*: With regulatory pressure increasing and the SEC rule on climate disclosure moving closer to finalization, how do you see ESG affecting executive pay in the immediate future?**

BB: We expect to see more climate-related metrics incorporated into compensation plans as disclosure on Scope 1, 2 and 3 GHG emissions are standardized and audited. Companies and their boards will become accustomed to setting goals, comparing themselves against peers and using these measures in their compensation programs.

The same goes for other regulations or rules that push companies for greater data disclosure around climate, DEI or human capital-related measures. Once companies start disclosing such data, it makes it easier for them to think about using these measures in pay programs. Plus, some investors will continue to push for them.