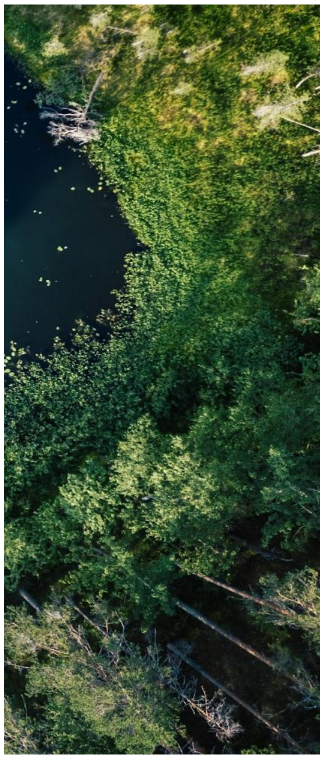
ESG in executive pay – The evolving landscape



With COP26 now well underway, the attention of the world's press, governments and businesses has been firmly on the climate crisis. The climate emergency demands vast changes in how businesses operate – this is being reflected by net zero commitments across all sectors of the market. While perhaps the most critical issue of the moment, climate is just one facet of the wider Environmental, Social and Governance ('ESG') agenda, which covers many areas including working conditions, safety, diversity and inclusion, biodiversity and waste.

The central role of business in tackling the significant environmental and social challenges faced today has resulted in increasing pressure from shareholders, employees and customers alike. One area of focus is linking executive pay to ESG, with companies, boards and investors seeking to leverage executive incentives as a tool to drive stronger ESG performance. Only two years ago, ESG in executive pay was a niche issue – but now, as pressure builds, prevalence has risen exponentially.

On 4 November 2021, Institutional Shareholder Service ('ISS') announced that it is proposing to assess ESG metrics in executive pay in a similar manner to financial metrics for companies in the UK, Ireland and Continental Europe (subject to a consultation process). This signals the importance with which investors are viewing progress on ESG issues – increasingly on a par with financial performance.

Earlier this year we published an in-depth study into the increasing link between executive pay and ESG, 'Paying well by paying for good'. Since then, the societal and commercial focus on environmental and social issues has escalated further. As a result, the use of ESG in executive pay is rising rapidly – as is the vocality of shareholders on this issue. Now nearly 60% of the FTSE 100 have some form of ESG measure in executive incentives. Our previous research showed that ESG in pay *can* be a valuable tool for driving alignment of executives to ESG and signalling intent to the market and other stakeholders. But we also demonstrated the complexity in doing it right, and the considerable risks of doing it in the wrong way.

PwC's 2021 global investor survey shows that:

- **Two thirds** of investors believe that ESG performance measures and targets should be included in Executive pay.
- **86%** of investors believe that ESG measures help to ensure managers focus on non-financial factors that drive long-term shareholder value.
- **50%** of investors believe that ESG measures should still be included in pay if these measures conflict with long-term shareholder value.
- According to **the majority of investors**,10% – 30% of executive incentives should be weighted to ESG.

Shareholder pressure has been one of the driving forces in the adoption of ESG into pay. While in previous years shareholder expectations were somewhat inconsistent – adding to the challenge faced by companies – we are now seeing much greater convergence of views. Now the majority of major investors are taking a positive stance on the use of ESG in pay and are sharing a generally consistent message around the importance of ESG measures being strategically aligned, quantifiable and assurable.

For example, in previous years Legal and General Investment Management ('LGIM') had stated that ESG targets in pay should generally take the form of underpins or modifiers to financial outcomes. However, their September 2021 executive remuneration guidance removed this comment, instead noting that the weighting of ESG metrics in long-term incentive plans should not exceed 30%, a level higher than current market norms. This change in position is a clear indicator of their support for (appropriate) ESG measures.

On 4 November 2021, ISS published a consultation on proposed changes to its voting guidelines. In its Continental Europe and UK & Ireland guidelines, this includes a proposal that the relevance and stringency of non-financial ESG metrics in compensation plans will be assessed in a similar way to financial metrics, with an expectation that performance targets should be "material to the business and quantifiable". As the world's largest proxy voting agency, this is a powerful signal that investors will seek to hold companies to a high bar for ESG metrics in pay. The consultation period on the proposed ISS changes closes on 16 November, with updated versions of their guidelines expected by the end of the month.

Some investors have already gone further. Earlier this year, Cevian Capital announced their intention to vote against any company that has not included ESG targets in executive pay by 2022. They think that the say on pay process can be used to create accountability between companies and their investors on the short to medium-term ESG goals that will lead towards longer term aspirations.

ESG is now a normal feature of executive pay – and one that is here to stay. But it is still a relatively new practice and we have not seen the full consequences, nor whether companies have successfully addressed the many challenges involved. Target setting in particular is complex for ESG issues – and we must wait to see whether the calibration done to date, particularly for long-term goals, is fit for purpose. If it is not, and if payouts come without the progress to justify them, then we will likely see investors take a tougher line, as ISS are proposing. For now though, ESG is fast becoming a standard component of executive pay and given the importance of ESG issues to society, this will be seen by many as a positive step.

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What is happening in the market?

Almost 60% of the FTSE 100 now have an ESG measure in their incentive arrangements, up from 45% last year.

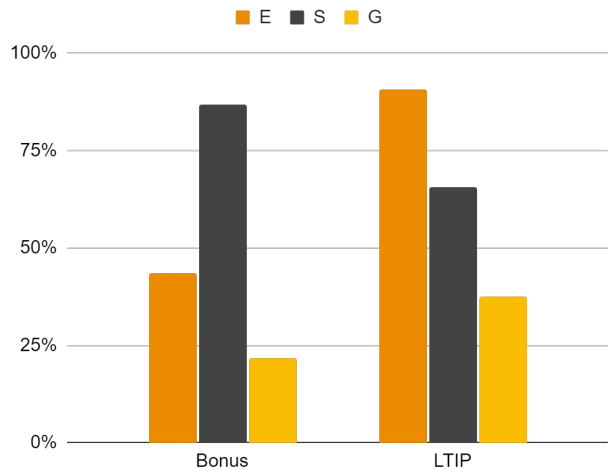
58% of the FTSE 100 now include an ESG measure as part of their executive incentive arrangements, an increase from 45% in our analysis last year. A number of companies have made further commitments to include ESG measures in their 2021 annual bonus, and our current discussions with remuneration committees indicate that prevalence could be as high as 75% next year.

46% of FTSE 100 companies included an ESG measure in the annual bonus in 2020 (up from 37% last year). Inclusion of ESG measures in Long-Term Incentive Plans ('LTIPs') has grown by 70% since last year, to **32% of the FTSE 100.**

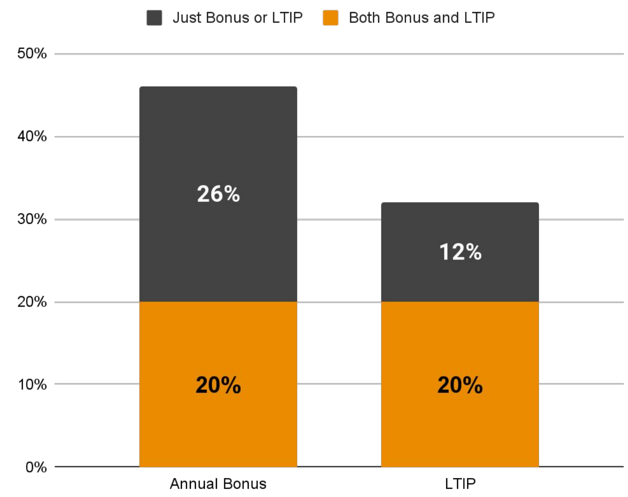
20% of FTSE 100 companies include an ESG measure in both their Bonus and LTIP – a clear indicator of strategic importance and the mixture of long and short-term priorities underpinning ESG.

The average weighting of ESG measures in the bonus is 16% and 20% in the LTIP.

Prevalence of ESG measures



% of FTSE 100 with ESG Measures



Social measures are still the most dominant ESG component within bonus plans. This includes a mix of more traditional, longstanding measures, such as health and safety and employee engagement, as well as issues such as diversity and inclusion, which are increasing in prominence.

As COP26 has shown, net zero is likely to be a dominant business issue of the decade. This is reflected in increasing prominence of decarbonisation metrics, with **28%** of the FTSE 100 now having a measure linked to decarbonisation and emissions reduction.

The most common ESG measure in long-term incentives continues to be environmental – likely reflecting the longer term nature of issues such as decarbonisation, as well as the need for companies to undertake long-term wholesale transformations to meet net zero ambitions.

[1] This analysis is based on stand-alone measures and underpins relating to environmental, social and governance issues. It excludes measures relating to customer satisfaction. Note that ESG components forming part of wider personal scorecards, but without distinct weightings are excluded. Bonus data relates to the bonus paid in respect of the last financial year (e.g. 2020 for December 2020 year ends), and LTIP for implementation in respect of the next financial year (e.g. 2021 for December 2020 year ends).

For further information, help or support…

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