ESG metrics in executive incentive plans

People Advisory Services

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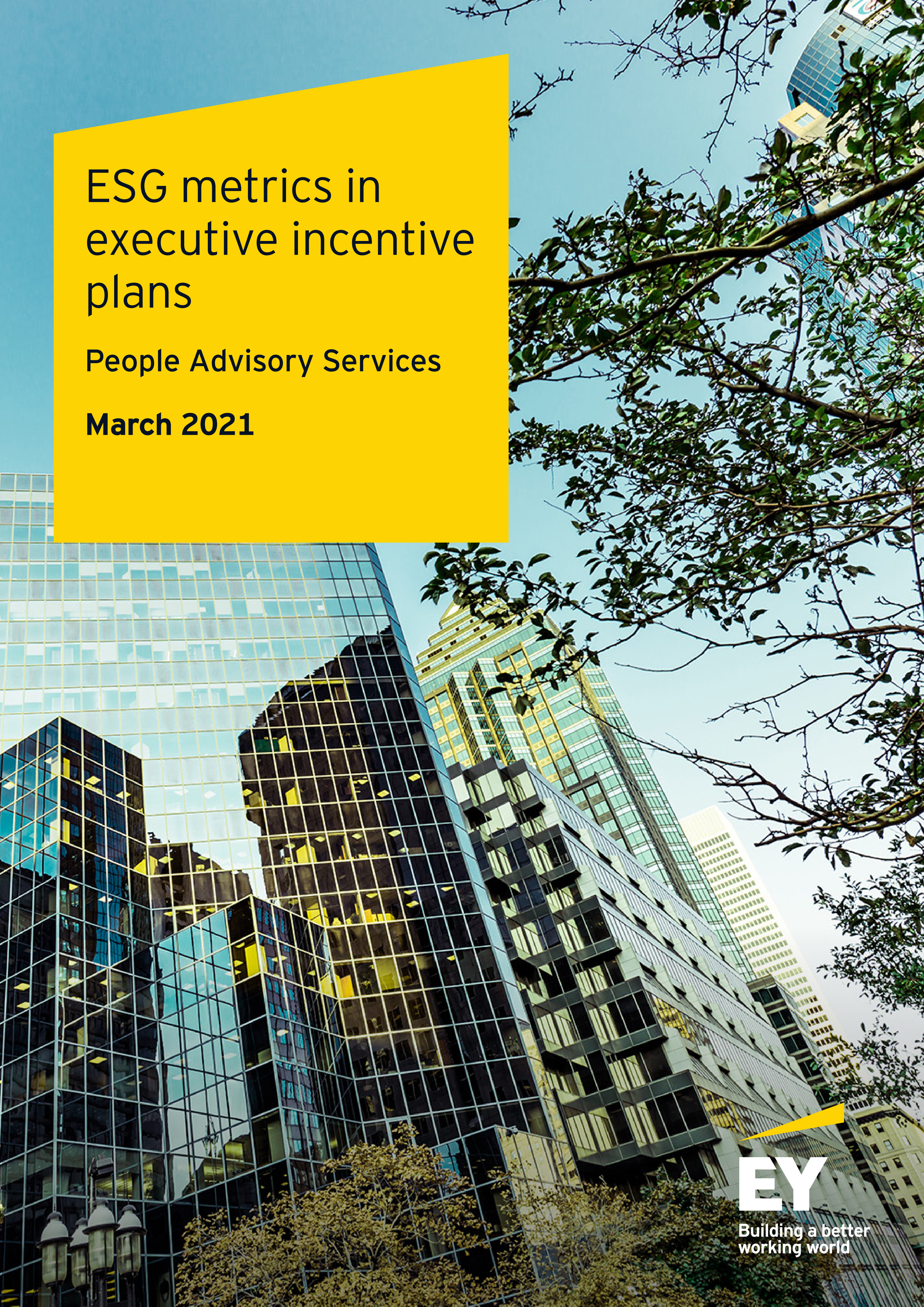


Building a better working world

Introduction

We've seen the investor focus on Environmental, Social and Governance (ESG) increasing over the last year, and effective disclosure of ESG risk and how this is being addressed is a key concern across all sectors. Whilst environmental measures attract most of the headlines, investors want companies to demonstrate that ESG is being considered and addressed across the broad spectrum of risk. Investors have also indicated they want disclosure in this area to improve to allow progress in this area to be more easily assessed.

Many companies have previously focused on statements of intent, but there is now a need to demonstrate action, and assessment and measurement are key enablers to show progress in this area. Investors want evidence that companies are moving from window dressing to commitment to embedding and monitoring across the business.

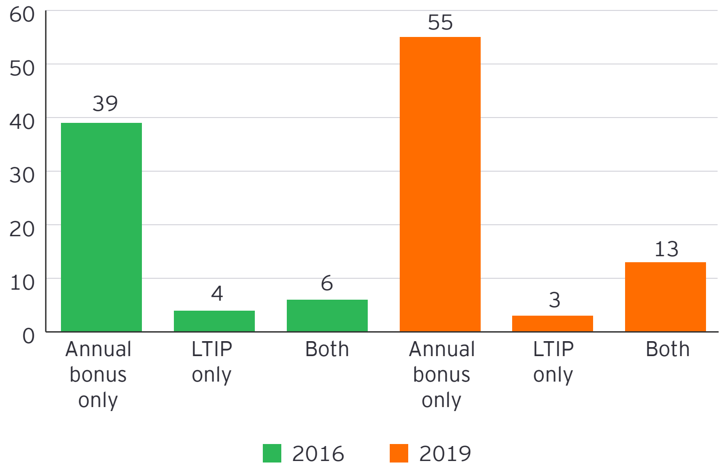
> Use and measurement of non-financial metrics is becoming increasingly important as a sign of company resilience and as a measure of long-term value.

One lever which can be used to demonstrate action is reward, and in particular incorporating ESG measures into short and long-term incentive plans. We know that this is a hot topic for discussion at the remuneration committee and board level, and many are seeking to understand what other companies are doing.

To support companies thinking in this area we have researched the way ESG has been used by companies and how this has changed over the last three years. It is clear that there is no "one-size fits all" response to incorporating ESG into either short or long-term incentive plans (LTIPs). There is no one consistent metric that can be said to be relevant to all (as is the case with many financial metrics such as profits and total shareholder return). It is not even the case that incorporating ESG metrics into incentive plans is the right thing for all companies. However it is a debate which remuneration committees need to be having.

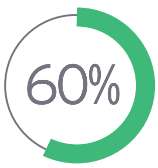
What is the market doing?

The number of companies in the FTSE 100 who employ an ESG measure has increased to c.70% from less than 50% three years ago:

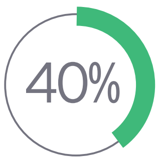


Overall the increase in use of ESG metrics suggests that companies increasingly recognise the importance of considering a definition of value which is more than just financial. However a closer look at the way in which these metrics are being used demonstrates that for the majority of companies either the weighting attaching to the metric is relatively low, or they are simply incorporated into a broader scorecard of personal or discretionary measures and no specific targets are disclosed.

The median weighting (for those companies that specify) remains constant at 10% for 2016 and 2019.



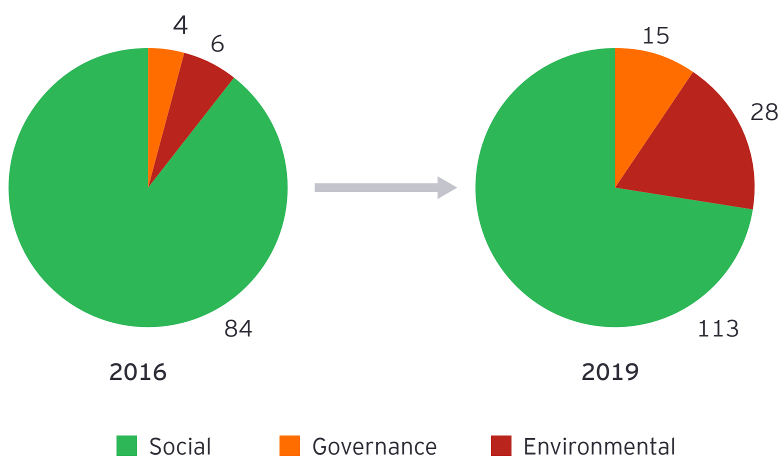
The majority (c. 60%) of companies use a weighting of less than 10% or incorporate ESG measures into a broader discretionary scorecard with no specific details.



The number of companies using a weighting of 10% or more has remained broadly static between 2016 and 2019 (c. 40% of companies).

Environmental measures were used by only 6 FTSE 100 companies in 2016, this had risen to 26 by 2019 including 5 companies who incorporate one or more environmental measure in their LTIP. This clearly reflects growing concern across society about the environment, but for many is unlikely to go far enough. The current focus on assessing environmental risk and ensuring this is appropriately managed may well lead to an increasing number of companies incorporating these metrics into incentive plans.

Prevalence of ESG metrics - 2016 and 2019



When we analyse specific sectors we can see that the % increase in use of ESG is broadly similar across all sectors although the actual metrics employed in each sector can vary:

- In the financial services sector we see a higher prevalence of governance metrics (e.g. governance processes relating to financial crime, AML, risk and compliance)
- In the extractive industries we observe a higher prevalence of health and safety metrics (e.g. lost time to injury frequency rate, embedding health and safety processes within organisation)
- Environmental measures have seen the biggest proportionate increase since 2016. These measures are mainly concentrated across the extractive, consumer and financial industries

Investors have expressed a clear view that financial performance should remain the primary driver of payments under annual and long-term incentive plans and current practice suggests that the inclusion of ESG may have been more of a communication exercise rather than a real driver of behaviour for many companies. A more meaningful weighting and clearly articulated targets against which performance will be assessed will be a key focus for investors as we go forward.

Looking ahead – what does this mean?

From a remuneration committee perspective the broader debate about what constitutes long-term value and the key drivers for this is a huge positive. In the same way that gender pay gap and CEO pay ratio figures perhaps don't necessarily provide insight when looked at in isolation, the fact that debate about these wider factors now takes place at remuneration committee reflects progress, rather than the situation a few years ago when the debate about executive pay took place primarily in a vacuum.

However to avoid this becoming a box ticking exercise each company needs to consider its own specific circumstances and tailor the conversation accordingly, rather than looking to the market for guidance.

Ultimately, whether or not ESG metrics are incorporated into the incentive plans, this is a debate which remuneration committees should be having. Investors will want to be sure that the remuneration policy and the design of incentive plans within this has been fully debated and that ultimately it can be linked back to the company strategy. There is therefore an emphasis on strong remuneration committee debate, and clear and transparent remuneration disclosures (and engagement where relevant).

We have outlined below a framework which can be used to help ensure that that the issue is debated in a logical manner which can then be used to drive the narrative once decisions are made. This focuses on three key steps:

- Strategy
- Structure
- Reporting and engagement

Looking ahead – what does this mean?

Investors and other stakeholders expect companies to give proper consideration of ESG risk for their business, and to report in a clear and concise manner so that they can make better informed investment decisions.

What this means for remuneration committees ...

Strategy

- The remco should consider the Board approved strategy and KPIs and the role of ESG within this. If ESG metrics are linked to incentives then there needs to be clear alignment with strategic goals. The remuneration committee should also consider to what extent metrics represent BAU versus business change.
- If the strategy does not include clear ESG KPIs and timelines then perhaps now is not the right time to incorporate such measures into incentive plans.

Structure

- If key ESG metrics are identified, what are the timescales associated with these?
- If long-term are there key milestones?
- Can broader goals be broken down into operational must-do's?
- Are targets clearly articulated or are they more general statements of intent?
- Which metrics are viewed as being business critical?
- Does the approach demonstrate commitment (specified targets) or is it window-dressing (e.g. general discretion)?

Reporting and Engagement

- Can a cohesive narrative be demonstrated across the strategic report and the directors' remuneration report?
- Do the messages reflect and support the organisation's culture and purpose?
- Can the approach be easily explained to investors, employees and other stakeholders?

However, the following are **not** the role of the remuneration committee:

- Determining the organisation's strategy and targets as it relates to ESG risk
- Designing incentives which reward executives for performance already being delivered
- To assume that it's right for every company to have ESG metrics

Company ESG data sourced from annual report disclosures up to 1 October 2020

How we can help

Our Strategic Reward Advisory team advises on all aspects of executive remuneration, including remuneration strategy, benchmarking, incentive design, corporate governance and remuneration reporting.

Further information

For further information, please contact one of the following or your usual EY contact:

Tony Gilbert
Associate Partner

tony.gilbert@uk.ey.com
+44 7887 856 693

Caroline Johnson
Director

caroline.johnson@uk.ey.com
+44 7717 447 665

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ED None

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