GETTING ON BOARD WITH INCENTIVISING ESG

What gets rewarded gets measured and done.

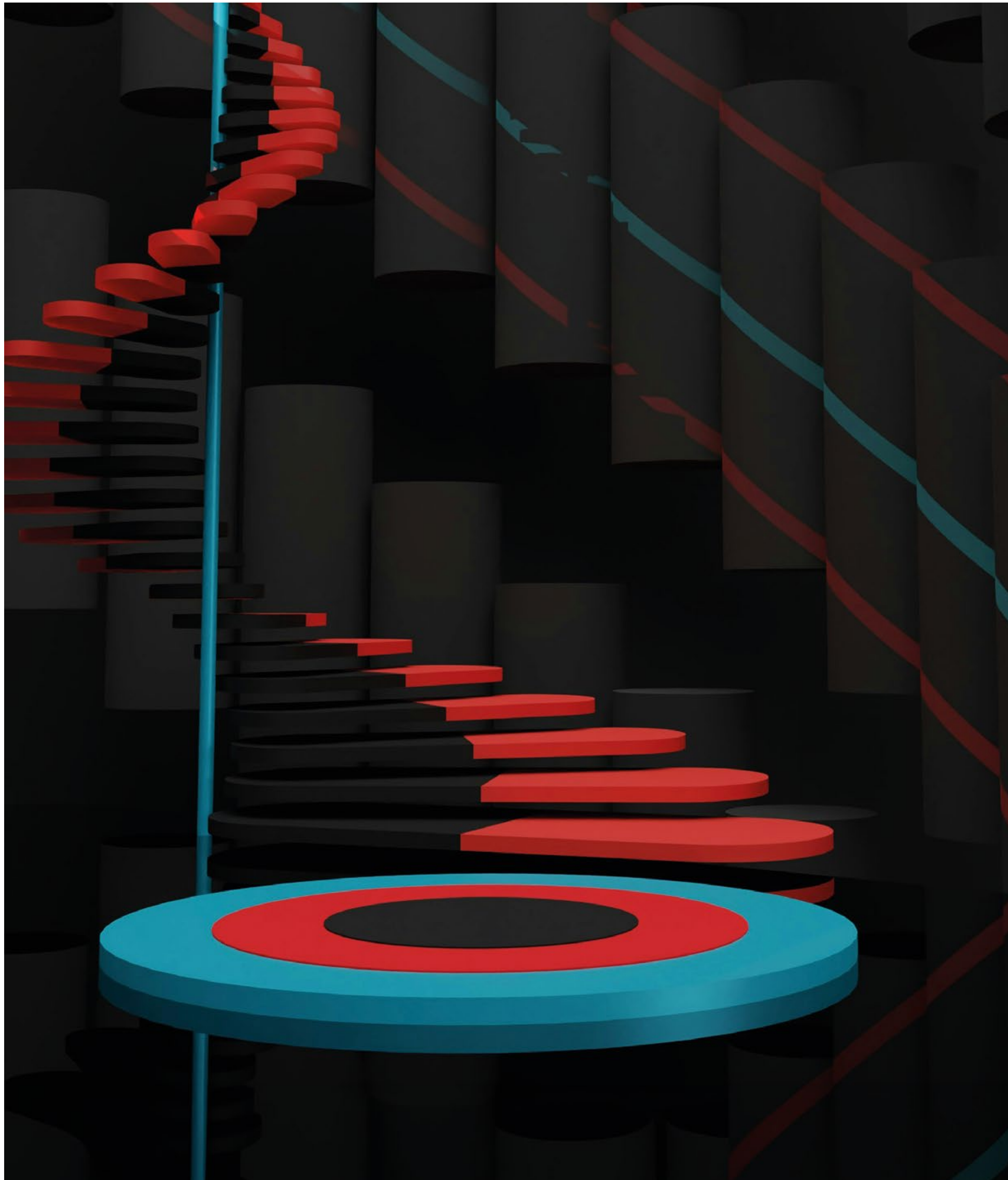
Managing Director and Global Leader of the Executive Compensation and Board Advisory business at WTW, Shai Ganu, speaks about the growing usage of Environmental, Social, and Governance (ESG) metrics in designing executive compensation.

How do you see the role of corporate governance evolving in response to the growing awareness and demand for sustainability, especially the need to address climate change?
WTW's Executive Compensation and Board Advisory team comprises over 500 consultants across 45 countries who work extensively with boards, compensation committees, nominations and governance committees, and sustainability committees globally. Across most regions and industries, one of the top five topics in any corporate boardroom is climate. So climate, and particularly climate transition, is becoming an increasingly important priority.

As climate and climate governance move up the agenda of companies and their boards, they need to progress to the next step, which is to align their corporate priorities with their executive compensation plans, because "what gets measured gets done". I'll go a step further to say, "What gets rewarded gets measured and gets done". When it comes to executive pay and climate change, we're seeing more companies aligning their incentive plans, be they short-term or long-term, with climate transition goals.

Over the last couple of years, we've engaged one-on-one with over 1,000 board directors on sustainability and stewardship. One of the issues that repeatedly came up was, "Why should we be paying executives more for doing the right thing?" Some may say that environmental stewardship, climate transition, and diversity, equity and inclusion (DEI) priorities–in other words, doing right for your employees and doing right by the community–should all be part of the job. In fact, that's what you get your base salary for.

Going back to incentives, the reason we are still proponents of this and why corporate boardrooms consider this an important priority is that when it comes to climate action, it's becoming clearer that we're



running out of time. The urgency warrants a stronger connection to executive pay to drive action.

I believe that aligning some of these goals to executive pay can help accelerate the transition, quicken mindset shifts, and catalyse action by management teams to drive the right behaviour.

However, incentives can also drive the wrong behaviour. As board members and compensation committee members, it's our responsibility to encourage the right behaviour and discourage the wrong ones, including greenwashing–or conveying a false impression about how a firm's products are environmentally-sound–and box-checking for the sake of governance or incentive requirements.

How have boards in Asia responded compared to those in other regions that seem to have had a head start in addressing sustainability challenges?

Since 2020, we've been conducting research at WTW on how companies are aligning executive pay with broader ESG priorities by examining their annual report disclosures and proxy statements. When we refer to ESG, 'E' includes climate, nature, biodiversity, and other broader environmental priorities; 'S' refers to social priorities such as employee well-being and equitable career opportunities; while 'G' represents governance priorities such as setting and tracking reasonable ESG goals that are aligned with company strategy.

Our latest research surveyed 1,200 companies globally in 2023.[1] We found that 81 percent have at least one metric in either the short-term incentive (STI) or long-term incentive (LTI) plan that's linked to broader ESG goals, as compared to 75 percent in the previous year. Over the last couple of years, we've seen a 10-percent increase in aligning ESG measures and incentive plans.

> As a specific bespoke KPI for one of my clients in Asia Pacific, 20 percent of the long-term incentive is linked to carbon emission reduction.

However, 77 percent of ESG measures are still short-term incentives—usually key performance indicators (KPIs) in their balanced scorecard. Only 27 percent of the companies link the measures to their LTI plans. LTI plans by design tend to have fewer KPIs, and some examples of these include total shareholder returns, capital efficiency measures, and the adoption of climate transition-related goals. One of the more common goals is metric tonnes of carbon dioxide equivalent reduction. But whilst still low in prevalence, the metric is gaining prominence.

If you look at the breakdown among the 'E', 'S', and 'G', the vast majority of companies still focus on measuring 'S' in their incentive plans. Only 53 percent of the companies have environmental goals.

We also found that Europe is the clear market leader, with 93 percent aligning ESG measures to executive incentives. We joke a little within WTW about this–that the 'E' in ESG stands for Europe! In Europe, environmental issues are at the top of every corporate boardroom's list of priorities. In fact, 56 percent of European companies have an ESG measure in their LTI plans. In most of these cases, the measures are specific environmental goals pertaining to carbon emission reduction, carbon intensity, or broader targets related to biodiversity, nature, water, and energy.

ESG issues are also gaining more prominence in North America and Asia Pacific. For American companies, more of them are aligning their short-term incentives, and in most cases, it's social-related or employee-related goals; only nine percent link them to the long-term incentives. So, clearly, there's more work to be done, but across the board, the trend is moving upwards.

In Asia Pacific, 77 percent of companies have some linkage to STI or LTI plans. However, there is room for improvement when it comes to aligning environmental measures with incentive plans. While 27 percent of companies have environmental goals in their STI plans, only 17 percent have such goals in their LTI plans. Asia Pacific companies also tend to take a more balanced approach of rewarding management for both effort and milestones via STI plans, as well as longer-term outcomes via LTI plans.

How should a company design an effective executive compensation plan that aligns with sustainability or climate objectives?

Companies that align their executive pay with sustainability or environmental goals do so not purely as a compliance or check-the-box exercise. They've identified sustainability as a business imperative because they not only see it as an integral part of their strategy or increasingly as a differentiator against their competitors, but also as a way to gain the hearts and minds of clients, as well as employees.

As we think about embedding ESG measures in incentive plans, we need a game plan, starting with prioritising the spectrum of issues that the company needs to address (refer to Figure 1). The next steps determine the approach and level of oversight required at the board versus committee level, and how to collaborate with management on the strategy and approach to address ESG priorities. Once that's decided, investors and the public must be educated on the issue(s) at hand and why the company has decided on its course of action.

A PRACTICAL APPROACH TO SELECTING THE APPROPRIATE METRICS

1. Prioritise the spectrum of issues the company needs to be addressing
2. Determine approach and level of oversight required at the Board vs. Committee level
3. Collaborate with Management on strategy and plan for addressing ESG priorities
4. Educate investors and the public on the issues—why addressing them is key to ensuring sustainability and long-term value creation, and how the company plans to deliver on its goals
5. Demonstrate commitment to initiatives by incorporating metrics that are specific and measurable, and stretch goals that are achievable and time-bound

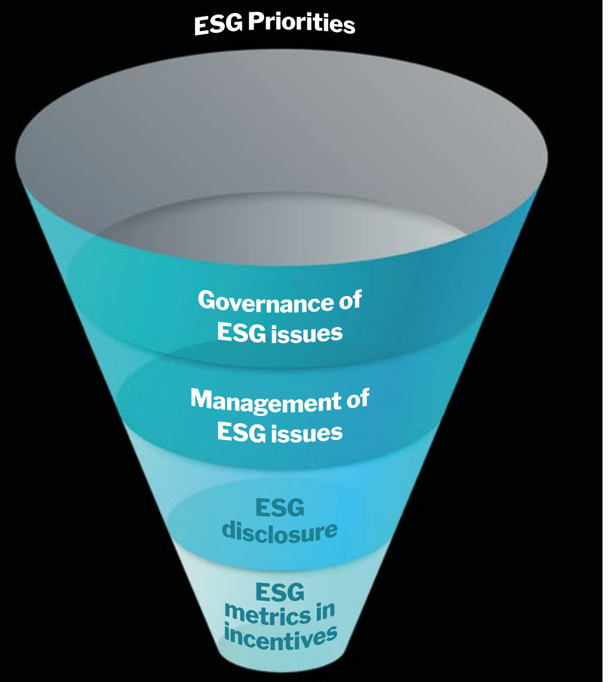


FIGURE 1 Source: Adapted from Shai Ganu, "Aligning Executive Compensation with Climate & Sustainability Goals," WTW, page 9.

We find that progressive companies are very good at crafting this shared collective purpose, which is achieved through elements of storytelling. I don't mean storytelling in the sense of greenwashing, but storytelling in the context of creating that shared purpose, that common North Star, and then aligning everybody internally and externally towards that main goal. And thereafter, demonstrate your commitment to the initiatives by incorporating those metrics into your performance appraisal system and incentive plans.

The funnel in Figure 1 helps by steering you away from picking a metric simply because your competitors use it or it appears in research reports. Instead, pick the metrics that are relevant to your business, which you can measure, track and monitor, and are aligned to your incentive plans.

What are some of the emerging trends on how Asia Pacific companies are integrating sustainability/climate-related goals into executive compensation, especially if they are different from other regions?

We use a design spectrum approach to guide this discussion. We start with one end, which includes what is lower impact and easy to put in place, while the other end would be the higher impact, more complex initiatives to implement.

In this design spectrum, the first step is an underpin, which is the easiest to implement. Underpins usually are a low watermark that says, "Unless this is achieved, unless you pass this gate, all bets are off." Generally, they have a high probability of achievement, so companies are not very stretched. But the reason you put in place these underpins is to send a signal to all employees and stakeholders, internally and externally, that this is really important to the company.

We then look at individual performance rating modifiers. You can have a climate or ESG-related goal, pertaining to individual elements of the STI or LTI plans, to modify the payout percentages. You can also have a company performance modifier like a weighted metric at the overall company level. This again modifies some of the formulaic bonus outcomes. This could be a specific metric in the STI plan, and we would suggest having a quantitative measure, such as the achievement of carbon emission reduction goals. As for weighted measures in the LTI plan, as I mentioned earlier, many companies, particularly in Europe and increasingly in Asia Pacific, are starting to align carbon emission reduction goals in their LTI KPIs. So as a specific bespoke KPI for one of my clients in Asia Pacific, 20 percent of the LTI is linked to carbon emission reduction.

The final one is my personal favourite. It's a separate stand-alone incentive plan, where typically five-year performance goals are linked to long-term sustainability priorities. One of the really interesting features is that it has a slightly different orientation of what good performance looks like. Most incentives are predicated upon the premise that time is constant and performance is variable. So in the STI, it's a one-year performance period; in the LTI, it's three years. At the end of the one- or three-year performance period, we assess whether you have achieved either your threshold, target, or stretch targets.

The stand-alone incentive plan shifts this paradigm. It says instead that performance is constant and time is variable. So what that means is you could tell executives that your goal is to achieve a 50-percent reduction in carbon emissions. If you achieve that goal in five years, that's target performance, so you'll get 100 percent of the reward. If you achieve that in four years, that's considered a stretch performance, and we'll give you a kicker. If it takes you six years–which is longer than we'd have wanted–we'll penalise you a bit. Thus time becomes a variable here and this reinforces the sense of urgency, specifically when it comes to climate transition.

Do not exclusively use qualitative or ambiguous metrics or goals. It can create a perception that you're using ESG or climate measures just to make management rich without making a real meaningful impact.

What advice would you give to companies that are just starting to design executive compensation that drives climate action?

It's increasingly important for directors to make sure that they're at least climate-literate, if not climate experts, and that they're also placing the same emphasis on it as what they've done for other aspects of governance. Specifically on the question of "What shall we do and not do when it comes to incentive arrangements?", I'll share the following dos and don'ts.

- Do continuously monitor and modify the measurement of your goals. Don't just add an ESG measure to check the box, or because everybody else is doing it.
- Do consider bespoke KPIs that are aligned with your ESG strategy and metrics. Don't just blindly follow market practice and do what your competitors are doing.
- Do measure short-, medium-, and long-term progress. Set long-term goals and then break them down into short- and medium-term goals, such as milestones. Don't just set annual goals with no long-term vision.
- It's important to "think long and act short". In other words, think long-term, but set these as measurable goals. Also, do select metrics and goals that are quantitative, clear, ambitious, transparent, and consistent. Do not exclusively use qualitative or ambiguous metrics or goals. Shareholders don't like that; proxy advisors don't like that either. It can create a perception that you're using ESG or climate measures just to make management rich without making a real meaningful impact.
- Do tell the story of how KPIs, pay, and incentives drive your sustainability and climate goals, and be transparent about it. For example, companies could at the time of the LTI grant disclose the specific carbon emission reduction targets, and at the time of vesting disclose the actual achievement. Progressive companies are transparent in their target-setting, both at the beginning and at the end of the performance period. Don't manage your annual reports, executive compensation disclosures, and sustainability reporting in silos. It may sound obvious, but we've worked with clients where the three teams managing these functions are just not talking to one another. That's not ideal. We all need to be connected.

What would be one final message you have for companies that are on this journey of climate and sustainability governance?

There's this famous line in the movie *The Godfather*: "It's not personal; it's strictly business." And that very much applies to our discussion. For sustainability priorities to be truly embedded, companies must focus on realising tangible commercial benefits. That's a really important call to action for all board members and corporate directors. The moral imperative may be admirable and very important, but it may not always be sufficient. For truly long-lasting and meaningful change, companies have to align moral imperatives with business priorities, as well as tangible financial and non-financial benefits of sustainability stewardship.

Finally to underline the urgency of the matter, I quote the late John Lewis, a congressman for the State of Georgia's Fifth District: "If not us, then who; if not now, then when?"

SHAI GANU
is Managing Director and Global Leader of the Executive Compensation and Board Advisory business at WTW

For the reference to this article, please visit https://tinyurl.com/38pufn2v or scan the QR code below.