Paying well by paying for good

There's a push for executive pay to be linked to ESG factors. Should this be done and if so how?

pwc

London Business School

Centre for Corporate Governance

Introduction

Environmental Social and Governance (ESG) considerations now sit at the heart of good business practice, and for some companies have become a central strategic pillar.

Society needs companies to play their role in addressing challenges ranging from social mobility to climate change. This would suggest that executives should be paid based on ESG performance. But this simple conclusion may not always be correct, and simplistically adding the wrong ESG metric into executive incentives can be unproductive, and worse, counterproductive.

This report is a partnership between PwC and The Centre for Corporate Governance at London Business School. We review what market practice and academic evidence have to say about linking executive pay to ESG.

We aim to help companies and remuneration committees, who, in the struggle to do the right thing, find themselves navigating complex and competing pressures. There is no single right answer, but we identify the underlying reasons why a company may (or may not) include ESG in executive pay and the consequences for measure selection. And we set out the principles and decisions required to design a good, effective and enduring ESG pay metric, if that is what a board decides to do.

We hope this report helps you structure your thinking, and look forward to the discussion we hope it will provoke.

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Market practice in the FTSE 100 shows the changing nature of ESG targets in executive pay

ESG targets are increasingly prevalent in pay

- 45% of FTSE 100 companies have an ESG target in the annual bonus, the Long-term Incentive Plan (LTIP), or both
- 37% use ESG in annual bonus with an average weighting of 15%
- 19% of the FTSE 100 use ESG in LTIP with an average weighting of 16%
- The most common category of measure in the bonus is Social, including measures focusing on diversity, employee engagement, and health & safety
- The most common category of measure in the LTIP is Environmental, typically measures focusing on decarbonisation and the energy transition

The nature of ESG targets is changing, with increased use of Environment and Social targets, particularly in LTIPs

- ESG targets relating to long-standing social and governance metrics such as health & safety, risk, and employee engagement have appeared in bonuses for some time. 33% of FTSE 100 companies incorporate such 'Old' ESG measures, 31% in the bonus and 7% in the LTIP
- 'New' ESG targets relate to more recently emerging stakeholder concerns, particularly around climate change, sustainability and diversity. 28% of companies have such measures, 18% in the bonus and 15% in the LTIP

A slight majority of ESG measures are output rather than input measures, with only a minority operating as an underpin

- 55% of ESG measures in bonus, and 50% in LTIP, are output measures with a quantifiable goal – for example scope 1 and 2 emissions reductions in tonnes against baseline numbers
- 31% of ESG measures in bonus, and 27% in LTIP, are input measures relating to specific activities a company undertakes – such as making investments in green energy sources
- Only 14% of ESG measures in bonus, and 22% in LTIP, operate as an underpin, despite this approach being popular with some shareholders

Nearly half of current ESG metrics are not linked to material ESG factors

- Over half (55%) of ESG targets are based on ESG dimensions categorised as material to the company under the SASB Materiality Map®. But equally, nearly half are not
- Of the 45% of targets not deemed material in the SASB framework, nearly half (45%) relate to employee engagement or diversity & inclusion – whether this should be deemed immaterial will be a matter of debate. Diversity metrics commonly appear in financial services incentives, following the Women in Finance Initiative

SASB: Sustainability Accounting Standards Board

Pay should be aligned with ESG, but that may not mean ESG targets

The need for businesses to take action on ESG issues is a given. Companies recognise that addressing climate risk or improving product sustainability will be critical to unlocking shareholder value growth, and shareholders and society at large expect companies to play their role in tackling the pivotal issues of our time. Pay should support these goals. But aligning pay with ESG won't always require inclusion of ESG metrics in pay.

The first port of call for Boards seeking to incorporate ESG into executive pay should be longer term pay with less reliance on short term financial targets

If, as is now generally accepted, companies that have strong ESG credentials in the right places perform better, then we could ask whether there is even a need for distinct ESG pay metrics. Research shows that there is strong alignment between shareholder value and ESG outcomes – but that this alignment only fully emerges over periods of 5 years or more, longer than the typical 1 to 3 year performance periods of executive pay. We also know that too much focus on performance targets distorts decision making and can have unintended adverse consequences. So pay can be better aligned with ESG simply by simplifying it and making it longer term (that is, by using restricted stock).

> "Pay should be aligned with a company's ESG strategy, but that may not mean including ESG targets.

But the natural alignment between ESG and long-term shareholder value may not be enough

Putting ESG targets in pay can communicate priorities and commitment internally and externally

Incentive targets can provide a clear indication of where a company is placing its focus and what it expects to achieve. Financial performance targets have long been seen by investors as a good guide to performance expectations. In the same way, ESG targets in executive pay can send a powerful signal about a company's ESG intentions. Setting ESG targets in pay can be a way of mobilising the organisation to shift the dial on an important priority.

The long-term share price is a less potent incentive further down the business

Employees below the most senior tiers of management often feel less able to directly impact share price. For these employees, the alignment between long-term shareholder value and ESG may not be an effective incentive to take action that conflicts with the short term financial targets they have been set – meaning companies may wish to include specific ESG goals for these employees. Consistency, fairness and the importance of 'setting the tone from the top' may therefore demand that executive incentives also include ESG.

ESG can sometimes take too long to show up in share price for lengthening the time horizon of pay to create an effective incentive

For many important ESG issues the market is only slowly efficient, and these factors may take a number of years to show up in share price. Because Boards must compromise between these long-term horizons and realistic CEO requirements about when they get paid, it is not always possible to use deferred share awards with a time frame long enough for ESG to be fully reflected in the stock price.

ESG issues can represent tail risks which may not be well captured by typical incentives

Ignoring some ESG issues can result in higher profits and shareholder value for a period of time. But there is a risk that, if ignored, ESG issues will result in sudden tail events with cataclysmic business and reputational consequences – think health & safety. An ownership model based on long-term stock may address this, but traditional incentives, focussed on shorter term metrics, may not be well placed to address these risks, and a counterbalance to ensure such ESG factors are considered may be justified – creating alignment not just to profit, but to how it was achieved.

The motivation for including ESG targets in pay may go beyond financial shareholder value

One argument for including ESG targets in pay is that ESG is aligned with shareholder value. Another is that it's not. If the motivation for ESG metrics goes beyond shareholder value, then boards need to consider carefully the basis on which they are being included. We see three potential justifications.

ESG targets can align companies with societal expectations that do not directly link to share price

Businesses may have an interest in showing they are on board with the big societal issues of the day. The "rules of the game" as defined by society go beyond the rule of law. This may be reflected in governance codes, voluntary initiatives, or simply reading the runes. Doing the right thing is important, and quite often the consequence for failing to do so is a loss of custom or of talent. Society will expect companies to take actions that might not immediately show up in share price, and there may be times when companies want to demonstrate their commitment to societal goals through how they set incentives.

Shareholder preferences may extend beyond financial value creation

Shareholders may have preferences that extend beyond shareholder value. This may relate to desire of investors to make socially responsible investments, the desire to support minimum labour standards or diversity goals, or where a shareholder wants to reduce carbon footprint across their portfolio. Often this can conflict with the pure shareholder value maximisation objective in a company – such as where an investor's best bet to reduce overall portfolio carbon footprint is the reduction of emissions in an Oil Major, even where this results in lower profits from that holding. In these cases, it can make sense for ESG measures to be included in executive pay to align to these non-financial shareholder preferences. Where shareholder preferences are used as the justification for including ESG measures, it's important to have a mechanism for collecting those preferences, especially given that views may differ between investors.

Companies are now focussed on their purpose – how they benefit society beyond just shareholder value. Action on ESG can be strongly aligned with this purpose, and aligning executive pay with this may be a logical next step

Where an ESG initiative is aligned to the declared purpose of a company, there is a rationale for this to be embedded in executive pay. Purpose must flow through every facet of an organisation, from day-to-day behaviours in the workforce, interactions with customers and the priorities of the CEO. If ESG is critical part of purpose, then it may be appropriate to feature it in executive pay.

Putting ESG targets in pay raises significant difficulties

Even where there's a case to introduce ESG targets into executive pay, the potential implementation challenges are significant and may outweigh the benefits.

Even if quantitative measures are available, it may not be clear which to use

ESG can be difficult to measure reliably. The lack of consensus on how to assess ESG has led to a proliferation of KPIs. The same company can be scored very differently by different assessors even on the same ESG dimension. It is difficult to strike the balance between being overly simplistic and excessively complex.

ESG targets can be hit while the point is missed

For example, hitting a board level gender diversity target while doing nothing to address management diversity or the gender pay gap may even be counterproductive by distracting attention from the fundamental issues. ESG goals will have qualitative dimensions that can rarely be captured in ESG metrics.

ESG targets can distort incentives

Setting pay targets for ESG can crowd out intrinsic motivation. And if a company has multiple important ESG dimensions then including just some in pay risks distorting management focus.

ESG targets are difficult to calibrate and assess

Non-financial and strategic incentive targets consistently pay out more than objective financial measures – by around 10% points on average. This suggests difficulties faced by boards with robust calibration of targets.

Executive pay is complicated enough already

Adding ESG targets to already multi-dimensional packages adds another layer of complexity with all the unintended consequences that may arise.

How to decide

If the rationale for including ESG metrics is as a path towards long-term shareholder value, then companies should focus on financially material ESG issues

Research shows that where companies outperform on the ESG issues flagged as material under the SASB Materiality Map®, then they outperform financially and in terms of shareholder returns. This is not the case where they outperform on immaterial issues. This means that if a business is seeking to incentivise ESG in order to primarily drive shareholder value, it is material metrics that should be the focus.

But where the goal is less explicitly linked to shareholder value (such as where the ESG issue relates to wider shareholder preferences, societal expectations and purpose) then there are four key decision rules Boards should apply.

- First, the action should reflect the company's purpose and values, so as to act as a reinforcement of the relationship and implied contract between a company and its stakeholders, including shareholders and wider society
- Second, the action should relate to a stakeholder that is material to the company
- Third, the action should be multiplicative, meaning that the stakeholder value created exceeds the cost
- Fourth, the company should have a comparative advantage in the action being taken compared to other organisations or bodies

We develop a structured framework of questions helps boards decide whether to incorporate ESG targets into pay

The questions below shouldn't be considered as a deterministic roadmap. But in general boards should be able to answer most of these questions in the affirmative before moving ahead with ESG measures.

Q1: Why are we considering including ESG targets in pay?

- What objective are we seeking to support?
- Are existing incentives incomplete or insufficient?
- Have alternatives to including ESG targets in pay been considered and rejected?
- Are there other benefits to including ESG in pay that we need to take into account?

Q2: Are our chosen ESG measures aligned with strategy and focussed on the big issues?

- Are the ESG measures aligned to a strategic priority?
- Do the ESG measures reflect material issues that require a step change in performance?
- Can we set appropriate stretch?
- Are there clear and assured measurement criteria?

Q3: Have we considered and mitigated the risks of including ESG targets in pay?

- Can we measure the ESG priority we want to support?
- Do the measures capture the ESG priority completely enough?
- Can we avoid distorting incentives?
- Can we keep our pay plan simple enough?

A more detailed version of this framework is provided in Section 5

How to do it

For boards that decide that ESG measures should be included in pay, there are four key design dimensions to consider.

A. Input vs output. Quantitative objectives such as reducing emissions lend themselves to output goals. Shareholders will also prefer objective output measures. But there are situations, such as a strategic transformation, where input goals are also useful for addressing ESG issues that need to be measured in a more qualitative way.

B. Individual KPI vs scorecard. Sometimes an organisation will have one or two critical ESG issues that tower above the others in significance, meaning that focussing on one or two KPIs may be appropriate. In other cases an ESG issue may be multi-dimensional with many different objectives. In these cases, a carefully constructed and transparently disclosed scorecard may work better.

C. Annual bonus vs LTIP. Market practice to date indicates that environmental goals will sit within the LTIP – which makes sense as these issues take several years for step changes to emerge. But some ESG targets, such as health & safety goals, can be robustly calibrated over a single year, and it is better to set well calibrated one year targets than vague long-term ones.

D. Underpin vs scale target. In most cases, ESG metrics will work most effectively as scaled targets, with threshold and maximum performance levels. This is particularly the case for transformational objectives, for example relating to energy transition. However, some issues will have pass or fail performance standards, below which reductions in payout are appropriate. Safety is a one potential example of this.

Closing thoughts

ESG targets in pay have their place but are no panacea.

If the motivation for including ESG targets is creation of long-term shareholder value, boards should consider whether other pay reforms, such as simplifying and lengthening the time horizon of pay could achieve the same objective. Or whether publicly committing to, and reporting on, targets would be as effective.

If a board decides to include ESG metrics in pay in support of shareholder value, then the focus needs to be on ESG dimensions that are material to the company. And they should be alert to potential unintended consequences: distorting incentives, hitting the target but missing the point, measurement and calibration challenges.

When incentivising an ESG factor that has an ambiguous or negative impact on shareholder value then boards need to be clear on the justification for their action. Is it to meet shareholders' non-financial preferences? Is it to accord with societal expectations? Is it because the ESG factor represents a litmus test for the company's purpose? If so, how are these being assessed and traded off against shareholders' financial expectations?

Whatever the motivation, any ESG incentives should be aligned with strategy, focused on the most material issues, use clear and understandable targets, and be genuinely stretching to achieve in full.

Incorporating ESG targets into executive pay can play a role in helping some businesses be a force for good in addressing the immense challenges we face today.

But adding ESG to pay is not a simple equation. The answer is not always what we expect, and the risks of getting it wrong are substantial.

Paying for good while paying well is a hard thing to do.

Paying well by paying for good

The increased focus on ESG factors.

The pressure to link executive pay to ESG.

> “
> In almost every shareholder engagement in the last 12 months the question of ESG in pay has arisen.

Section 1

Introduction

The rapidly developing ESG context

COVID-19 has dominated the business agenda for the past year. But despite, or perhaps because of, this there is increased focus on the immense long-term challenges companies face: environmental degradation and a changing society.

Arguably the most significant of these is climate change. The world has to halve greenhouse gas emissions in the next decade to avoid warming of more than 1.5 to 2°C. Action can no longer be postponed to the future. Put in pay terms, this gives just three back-to-back LTIP cycles to transform every sector of the global economy. Companies are at the heart of this change, and increasingly recognise their responsibility to decarbonise to protect investors, employees, customers – and the societies they serve.

On its own climate change would be the greatest challenge humanity – and business – has ever faced. But alongside this, companies are facing pressure around their role in a broad range of environmental and social challenges: the loss of biodiversity, deforestation, water pollution, plastic consumption, wealth inequality, employment conditions, diversity and inclusivity and many more. The pressure is coming not just from special interest groups but from customers, employees, and, increasingly, investors and regulators.

Investors face scrutiny from their clients on how they are responding to ESG issues. As Larry Fink said in his recent letter to companies “They ask us about it [climate change] nearly every day”. Flows into ESG funds nearly doubled in 2020 compared with the prior year. But beyond this response to client demand, ESG integration is increasingly viewed by investors as a vital part of the investment process. This is supported by the body of evidence pointing to the importance of material ESG factors to long-term risk-adjusted company performance. Companies that prioritise sustainability continuously engage with their material stakeholders, making them better placed to react to social, economic and regulatory changes.

Financial regulators have long been interested in the G of ESG. But the E and S are also coming under scrutiny. Regulators see climate change as a material risk to financial stability. The transition and physical risks posed by climate change challenge the resilience of bank loan books and insurer policy portfolios. In a ‘Dear CEO’ letter to companies last year, the UK’s regulators stressed the importance of firms incorporating climate risk throughout their business model and governance. But they have also taken a strong interest in diversity and inclusion as an important signifier of a healthy culture.

So we have seen ESG expand far beyond its historic Governance focus. The change required to address the social and economic challenges we now face is vast in scale and pressing in time. Business leaders increasingly view it as part of their role to assume responsibility for playing a proper role in delivering the environmental and social agenda. The Business Roundtable reflected this sentiment in August 2019 with their revised statement on the purpose of the corporation, which symbolically listed shareholders last in a list of stakeholders the CEOs pledged their companies to serve. The pandemic gave companies and investors the opportunity to put their words into practice with initiatives to support customers, employees, and suppliers affected by the crisis, while contributing resources to national health efforts.

Calls for a link to pay

It’s only natural, given this context, that attention is turning to how ESG factors are being linked to executive pay. If CEOs say that ESG is so important then surely they should put their money where their mouth is and agree to be paid accordingly? As we’ll see the answer isn’t as obvious as it first seems. But calls to link executive pay to ESG targets are now widespread and not just coming from pressure groups and NGOs but also from investors and financial regulators.

In a high-profile example, European investors in Shell encouraged the company to add climate goals to its long-term incentive plan following their 2017 commitment to reduce their Net Carbon Footprint. BP has announced a similar change to incentives following CEO Bernard Looney’s strategy announcement in 2020. Financial regulators and governments are asking firms to consider incorporating climate and diversity goals into CEO pay. Cevian Capital has announced that it will be pushing all investee companies to set out ESG strategies and link them to pay by 2022.

Indeed, in almost every shareholder engagement in the last 12 months the question of ESG in pay has arisen. Nearly every Remuneration Committee is asking if, and how, ESG should be incorporated into executive incentives. Across the Atlantic, ESG has been slower to find its way into executive pay than in the UK – although Apple, the world’s most valuable company, has recently added an ESG modifier to its pay scheme, signalling that change may be about to increase pace in the US too.

Not so easy

But linking ESG and pay is not easy. By and large investors do not yet have a consistent or rigorous view about what 'good' ESG performance looks like – and so there is no clear guidance for companies on a 'good' ESG performance measure. One of the issues is the lack of a generally accepted set of ESG metrics. While ESG reporting standards now abound, such as the GRI or the new WEF/IBC standards, finding ones which are appropriate for incentives is much more challenging. Standardised ESG measurement frameworks tend to focus on 'doing no harm' as opposed to the more important dimensions of 'doing good'.

Climate is an area in which metrics are increasingly prevalent, but even here moving beyond the well-defined Scope 1 and 2 metrics into Scope 3 is challenging. And the relevance of such Scope metrics is variable depending on the balance of transition and physical climate challenges a firm faces. With investors innovating to create measures of Paris-alignment in portfolios and with TCFD disclosures across sectors providing more information, we can expect rapid progress in the coming years. Diversity is another area where a more standardised set of metrics is available. But again, it is not always clear that blunt metrics on, for example, board diversity really address the challenge of creating a diverse and inclusive culture.

Calibration can be even more challenging than choosing targets. Often companies find that the ESG measure which best aligns to their sustainability strategy is rather difficult to calibrate effectively with the fear of ever moving goalposts.

To link or not to link?

Despite these challenges the prevalence of ESG targets in executive pay is growing. Nearly half of all FTSE 100 companies now have an ESG metric in their bonus or LTIP. Yet some boards and investors question whether it is right to include ESG metrics in pay at all. If ESG is aligned with business strategy and long-term value, why does it need to be separately measured? If ESG defines a firm's licence to operate then why is it rewarded rather than being table stakes for the executive to keep their job? If neither of these, then is it just virtue signalling? Can ESG be linked to executive pay in a way that avoids being overwhelmed by unintended consequences? Perhaps linking executive pay to ESG is an example of what the early 20th Century commentator H. L. Mencken was talking about when he claimed that "every complex problem has a solution which is simple, direct, plausible – and wrong".

In this report we aim to shed light on these issues. In Section 2 we paint a picture of current practice in the UK. This will look at what metrics are used, but also how they are used. In Section 3 we then look at whether and how ESG should be reflected in executive pay. Just because we want ESG doesn't mean we should pay for it – indeed there are some strong arguments that we should not. We show that aligning pay with ESG isn't always about including specific ESG metrics in pay plans, although it can be. We draw on the relevant academic evidence to inform our views. We use these insights to present in Section 4 a framework to help companies decide whether and how to incorporate ESG metrics into pay, in a way that is strongly grounded in their purpose and aligned with value creation. In Section 5 we outline practical considerations and guidelines for defining ESG measures, and illustrate this with a hypothetical case study in Section 6. We summarise our conclusions in Section 7.

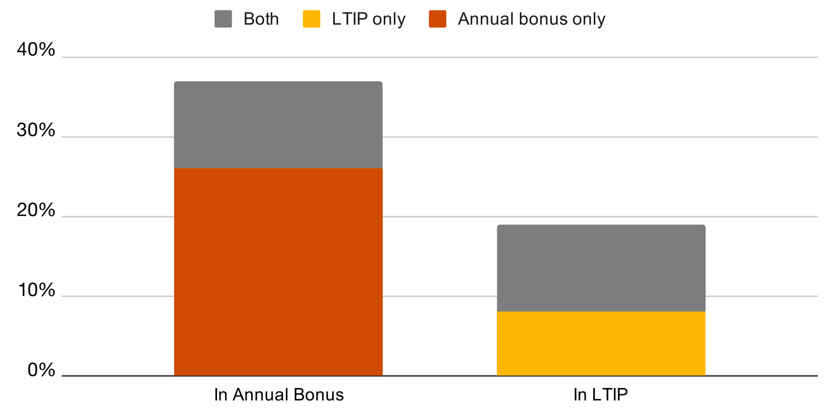
ESG as a core tenet of good business practice is here to stay. But does that mean we should link it to pay? Sometimes, but not always. And maybe less than we'd at first think. Companies and remuneration committees face a genuine challenge to navigate the right route through the competing demands placed upon them. We hope that this report will help you find an answer to this question that works for your circumstances.

Section 2

What is current market practice?

ESG in incentives

Percentage of Companies in FTSE 100 with at least one ESG measure in the following incentive



Data is based on disclosures released in 2020 (see page 15), and we expect a greater number of companies to include ESG measures in their 2021 disclosures.

45%

of FTSE 100 companies now have an ESG measure in executive pay

- ESG performance measures are rapidly increasing in prevalence, with nearly half the FTSE 100 having some form of ESG measure or underpin
- ESG measures are most common in the bonus, where 37% of companies have a measure
- 19% companies have an ESG measure in their LTIP

The E, the S and the G

Social measures are most common overall – but environmental is most common in the long-term incentive

% of companies	ESG	E	S	G
Bonus	37	10	32	11
LTIP	19	11	8	7
Overall (Bonus or LTIP)	45	18	37	16

The table below summarises the types of measure we have classified under E, S and G

Environmental	Social	Governance
• Decarbonisation • Energy Reduction • General Environmental • Plastic Reduction • Water Usage	• Diversity & Inclusion • Employee Engagement • Safety • Societal/ Communities	• Strengthening or remediating governance • Risk

- **Social measures are most common**
  This generally reflects the prevalence of employee metrics – but also health and safety and increasingly diversity
- **Environmental measures are rapidly rising in prevalence and are now the most common type in the LTIP**
  Environmental goals are generally long-term in nature – lending themselves to longer term targets. Environmental issues may, for some companies, be those with the most significant and clear impact on shareholder value – hence motivating inclusion in the LTIP. Governance measures are similar in prevalence to environmental. For Governance, we include measures incorporating risk and broader governance surrounding ESG issues

Old vs. New ESG

ESG performance measures have been in pay for years – but most typically in the form of risk, safety or employee metrics. Now, a new class of ESG measure is emerging, centred on the environment, society and communities. It is helpful to distinguish between these two classes of metric as we examine the data.

'Old' ESG

'Old' ESG measures generally relate to fulfilment of regulatory requirements or the management of risk – and are focussed on the stakeholders over which the company has close control and a direct, explicit line of sight to shareholder value.

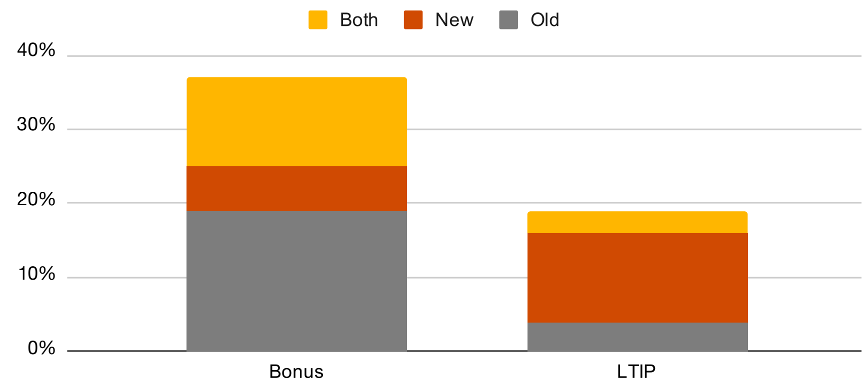
For our analysis, we have classified the following as 'Old' measures: those relating to Risk, Employee Engagement and Employee Health & Safety.

'New' ESG

'New' ESG measures are those which are now increasingly being incorporated in pay and which represent a company's obligations to a wider range of stakeholders. These 'New' ESG measures will link to a company's wider sustainability and social responsibility ambitions.

For our analysis, we have classified the following as 'New' measures: those relating to, amongst others, Communities, Decarbonisation, Diversity, Plastic Reduction and other sustainability goals.

- In the annual bonus, 19% of companies incorporate only an 'Old' ESG measure or underpin, 6% of companies have only a 'New' ESG measure and 12% of companies have both
- In the bonus, 'Old' measures, which are more established, have a higher weighting than 'New' measures (average 13% for 'Old' vs 7.8% for 'New' measures)
- In the LTIP, 4% of companies incorporate only an 'Old' ESG measure or an underpin, 13% of companies have only a 'New' ESG measure and 2% of companies have both



Case study: Croda

Croda weight 10% of the Performance Share Plan to Sustainability. 5% focuses on the development of decarbonisation roadmaps, with 5% in relation to measurable reduction in our Scope 1 and 2 emissions over the next 3 years.

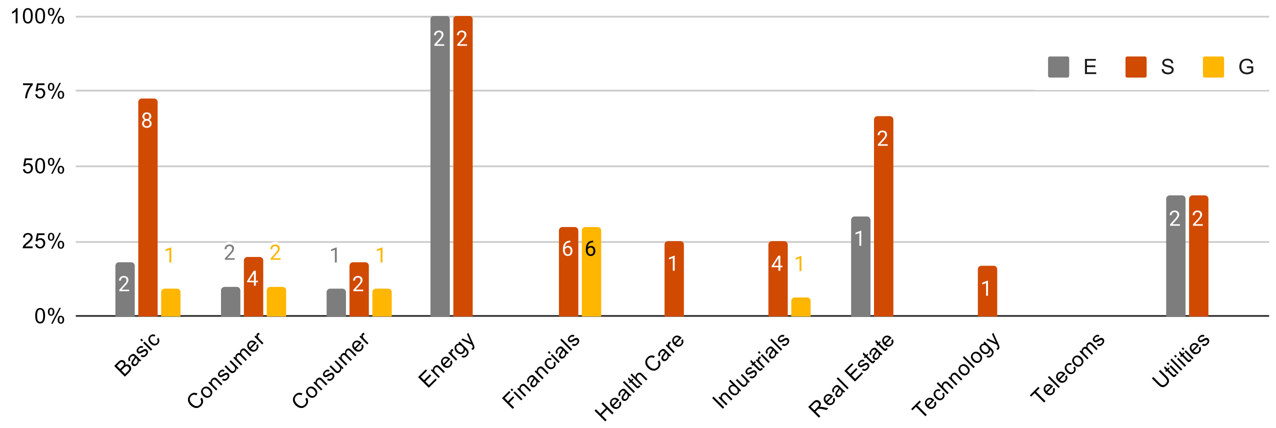
Data Sources

We reviewed the public disclosures of FTSE 100 companies released in 2020. Annual bonus targets are published in detail at the end of the year to which the bonus relates. Therefore, data for annual bonus targets relates to targets operated in the 2019 or for March or later year ends, the 2019/20 financial year.

There is no single definition of what is and is not an ESG factor. We follow the categorisation in the SASB Materiality Map®. This does not include customer satisfaction as an ESG measure, given its direct link to shareholder value, but does include customer welfare (for example as used by gaming companies). Including customer satisfaction increases the proportion of FTSE 100 companies using ESG targets to 43% in the bonus and 22% in the LTIP.

37% of FTSE 100 companies have an ESG measure in the annual bonus

% of Companies in each Sector which use E, S or G Measures in Bonus



The graph shows the usage of E, S, and G measures in annual bonuses by sector.

For each sector we show both the percentage of companies within that sector using an ESG measure as well as the number of companies this represents. For example, 100% of the Energy sector use ESG metrics – but this refers to two companies.

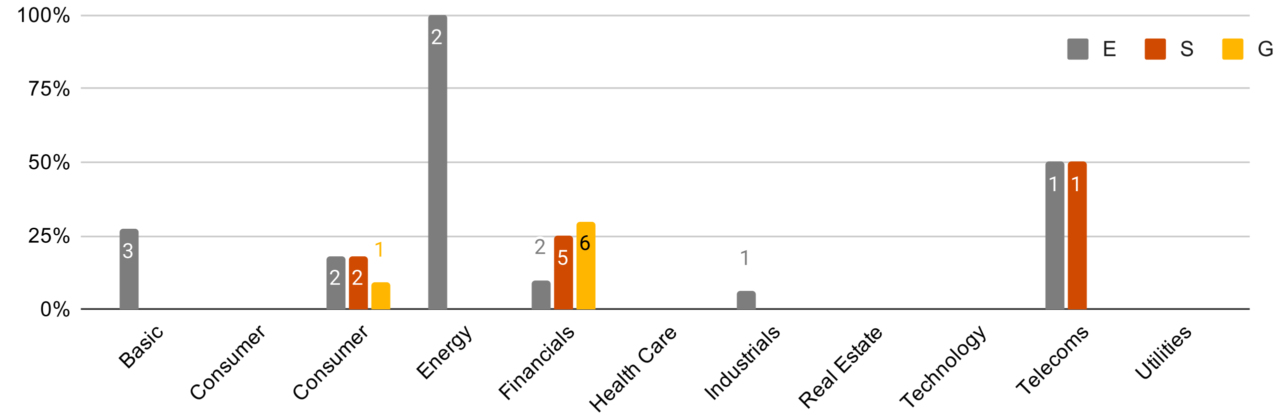
Case Study: BP

BP operate 'Old' safety measures, weighted 20% of the annual bonus, focusing on process safety tier 1 and tier 2 events, and recordable injury frequency. Additionally, 10% of the annual bonus is a 'New' Environmental measure, which measures 'Sustainable emissions reductions' in mte over an annual period.

- The average weighting of ESG measures is 15% of the bonus
- The majority of companies using ESG measures in the bonus focus on Social issues (86% of companies with an ESG measure in the bonus have an S measure) – primarily around employee issues and health and safety
- Governance measures are second most common, with the highest average weighting (10.1% average), typically found in the most regulated industries e.g. Financial Services. These are generally risk related measures
- Environmental measures are least common in the annual bonus. This will generally reflect the fact that environmental issues are the most recent ESG factors to become critical for businesses (given employee and risk issues have been focussed on for some time in certain sectors). It is interesting to note however that in the LTIP, environmental issues are the most common type of ESG metric – see next page
- Safety is the single most common ESG measure. This is an 'Old' ESG measure found commonly in companies where employee safety risks are higher

19% of FTSE 100 companies have an ESG measure in the LTIP

% of Companies in each Sector which use E, S or G Measures in LTIP



The graph shows the usage of E, S, and G measures in LTIPs by sector.

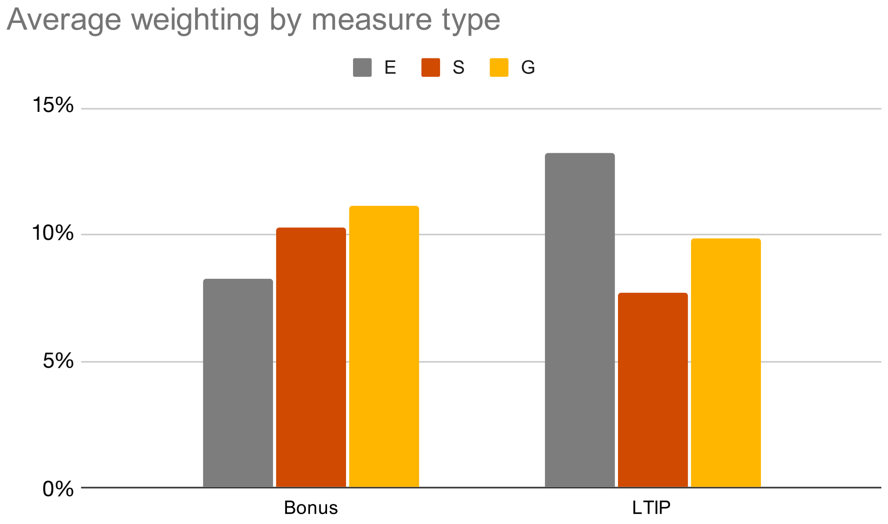
For each sector we show both the percentage of companies within that sector using an ESG measure as well as the number of companies this represents. For example, 50% of the telecommunications sector use ESG metrics – but this refers to one company.

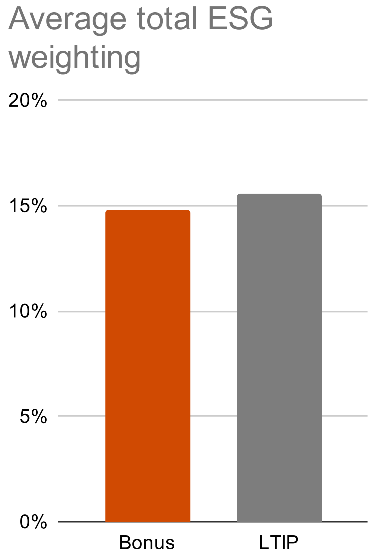
Case Study: Prudential

Prudential include a 5% Diversity measure in the LTIP assessing the "Percentage of the Leadership Team that is female at the end of 2022. The target for this metric will be based on progress towards the goal that the Company set when it signed the Women in Finance Charter, specifically that 30 per cent of our Leadership Team will be female by the end of 2021. 20% vests for meeting the threshold of at least 27% of our Leadership Team being female at the end of 2022, increasing to full vesting for reaching the stretch level of at least 33% being female at that date."

- The average weighting is 16% of the total award
- The majority of LTIP ESG measures focus on environmental issues (60%) – such as greenhouse gas reduction, transition to renewable energy and energy management
- Environmental measures are most commonly seen in the energy and basic materials sectors – where the average weighting is 20% of the total award
- In most other sectors environmental measures have a much lower weighting – c. 3%-5%. This may reflect difficulties in target setting, lower levels of materiality – or a desire to 'dip a toe in the water' before committing more fully
- Financial services companies also commonly include ESG within the LTIP – generally around risk, employees and diversity – but also increasingly around communities and the environment

Average weightings of ESG measures





15%

The average weighting of ESG measures is 15% in the bonus

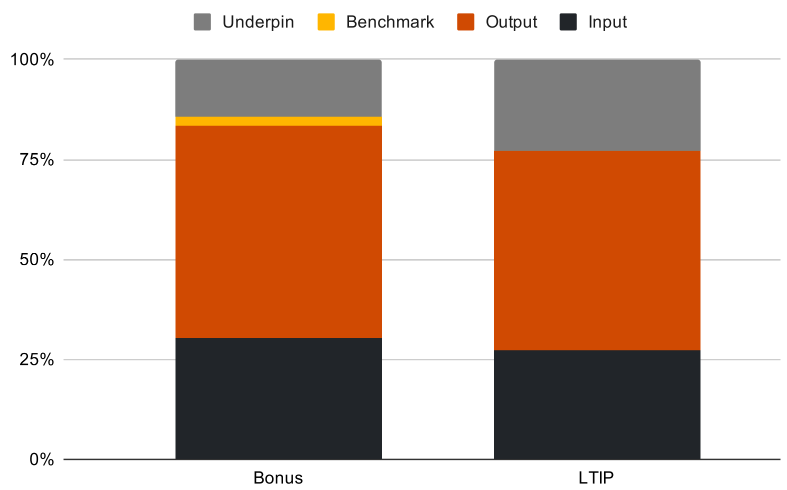
16%

The average weighting of ESG measures is 16% in the LTIP

- The average weighting of ESG measures is 15% in the bonus
- The average weighting of ESG measures is 16% in the LTIP
- Social and Governance measures have the highest average weighting in the annual bonus
- Environmental measures have the highest average weighting in the LTIP

Input vs. output

How are we measuring measures



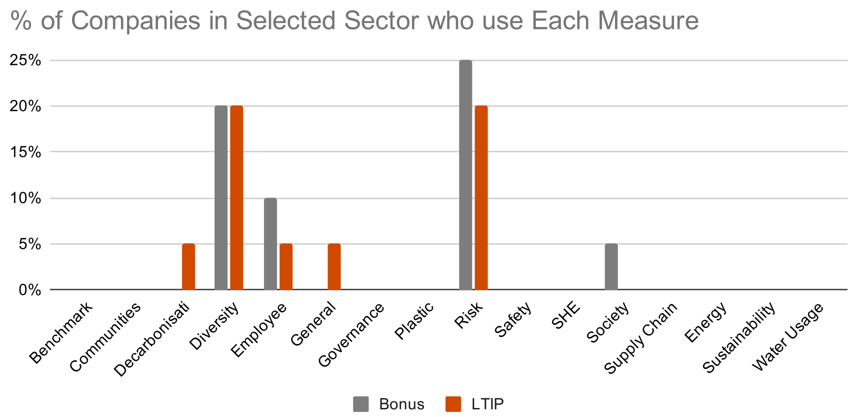
For the analysis above, we have classified output measures as those with quantifiable targets against which performance is assessed (e.g. % reduction in GHG emissions, % of women on boards).

- Output measures are more common than input measures in both the annual bonus and the LTIP. This will undoubtedly reflect the preference of investors for rigorously assessed targets for non-financial goals
- In the LTIP, input measures are even less common than in the bonus. Non-financial and input targets have always been less favoured in the LTIP – and this is reflected in ESG practice
- Underpins in the bonus focus on health and safety outcomes. Risk underpins are also seen in both the bonus and LTIP – particularly in more regulated sectors. Some investors express a preference for ESG performance to be included as an underpin in Executive incentives, and not as a standalone measure

Sector Spotlight: Financials

Financial services have a high prevalence of ESG metrics in executive pay. This is driven by a long standing focus on inclusion of risk measures within executive pay ('Old' ESG) – but also the requirement of the Woman in Finance Charter that diversity targets form part of executive remuneration ('New' ESG).

We are now aware of a number of financial services businesses considering climate related goals within pay. This reflects the concerns of regulators on the risk climate change poses to the global financial system, and is bolstered by calls from some commentators (including Mark Carney) that banks should link climate goals to executive pay. The financial system is increasingly viewed by policy makers as a channel through which progress on climate change across the economy can be accelerated – placing a greater spotlight on the link to pay in this sector.



- 60% of the 20 Financial Services companies in the FTSE 100 include an ESG measure in executive pay
- This breaks down as 50% in the annual bonus, 35% in the LTIP – and 25% with both a bonus and an LTIP measure
- These are generally either risk related metrics – or those relating to diversity and employees
- These measures tend to have material weightings across both bonus and LTIP:

	Average Weighting	
	Bonus	**LTIP**
Diversity	6.7%	5.3%
Employee	21.5%	8.0%
Risk	14.0%	10.3%

*this analysis excludes underpins which cannot be assigned a weighting

We note that there are several companies, in addition to those detailed above, which reference ESG goals (these are primarily in relation to diversity targets) within a strategic or individual category for the annual bonus. These are not captured in our analysis, which focuses only on cases where there is a separately identified ESG KPI, or basket of such KPIs, with a specified weighting.

Voluntary Regulation

- The Financial sector is a good example of how voluntary regulation has accelerated the inclusion of ESG in executive pay
- The Women in Finance Charter was initially published in 2016, with over 330 companies since becoming signatories
- As part of signing up to the charter, firms must commit to linking Senior executive pay with gender diversity targets
- The average weighting of diversity related measures in the annual bonus is 6% and in the long-term incentive plans is 5%

60%

of the 20 Financial Services companies in the FTSE 100 include an ESG measure in executive pay.

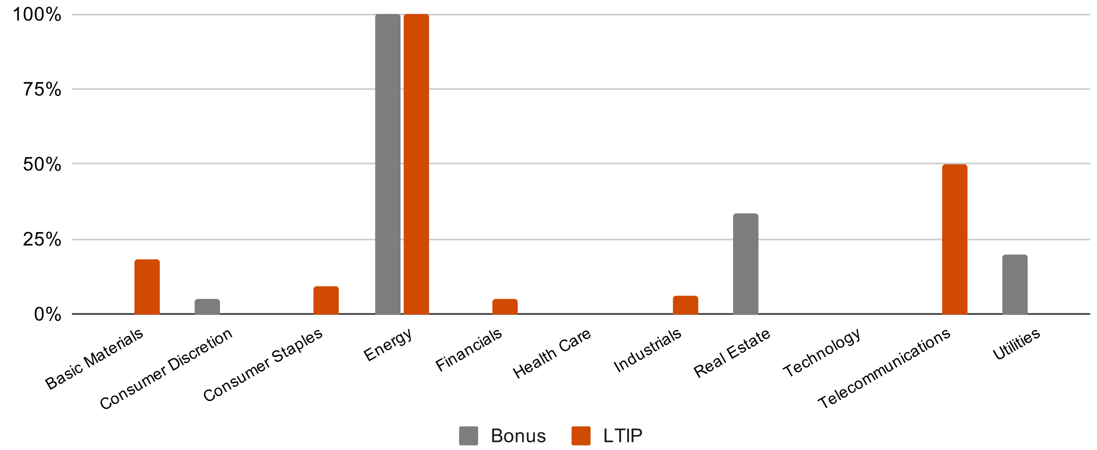
18%

The average total weighting of ESG metrics were used in FS.

Measure Spotlight: Decarbonisation

Climate change and the transition to net zero is probably the most talked about, the largest scale and most politically discussed ESG issue. This means that when we talk about ESG, it is natural that people's minds first turn to decarbonisation and net zero. Overall, 11% of companies have a metric related to carbon reduction in their bonus or LTIP – primarily focussed on the energy sector, utilities and natural resources where the impact is greatest.

% of Companies in Each Sector who use a Carbon Reduction Measure

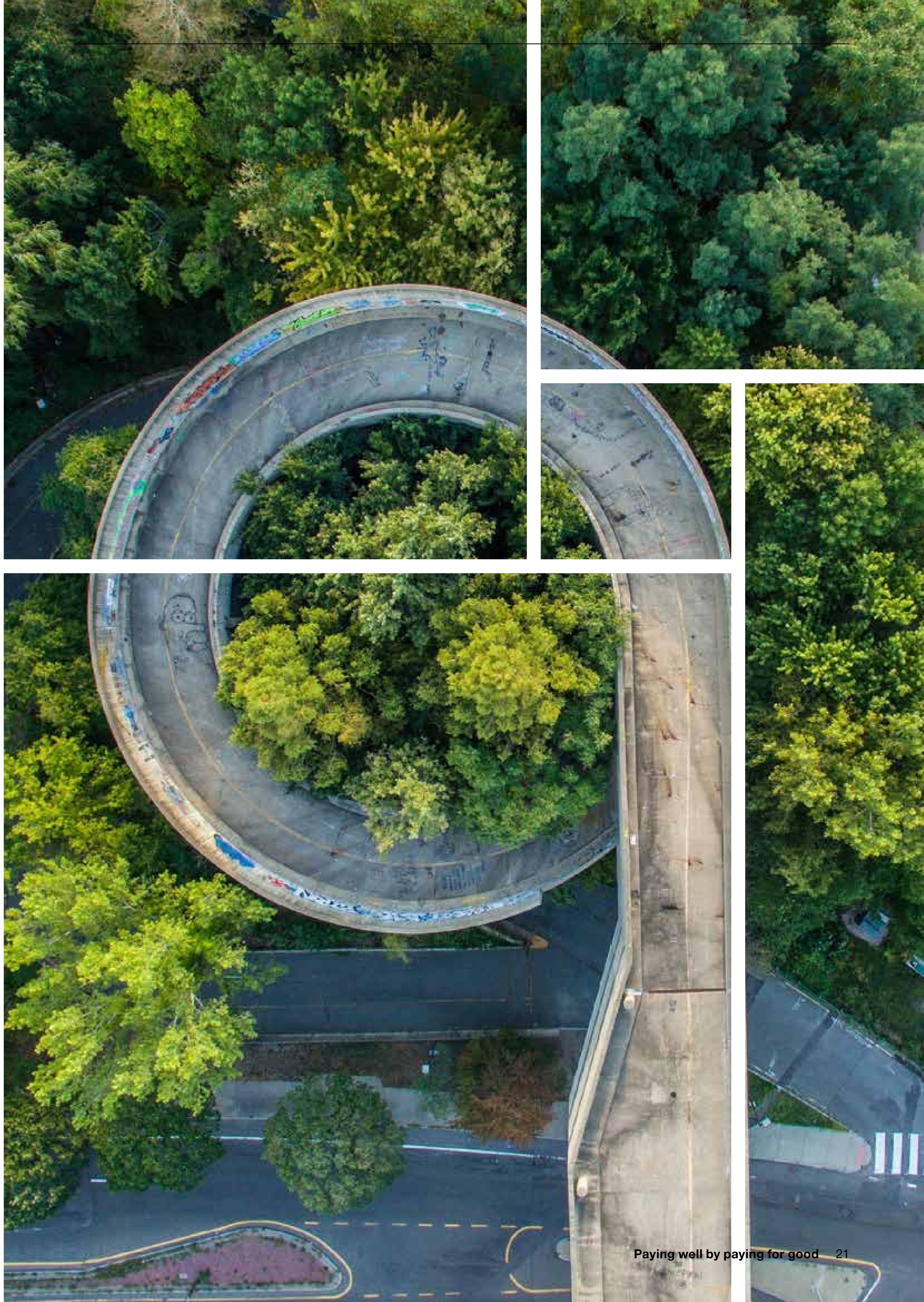


In the Annual Bonus

- Decarbonisation measures are either output (GHG reductions) or input (adoption of renewable energy sources/investments in renewable technology)
- Decarbonisation measures in the annual bonus focus on Greenhouse Gas emission reduction targets, and input metrics such as the adoption of renewable energy sources and investments in renewable technology
- They are still relatively uncommon in the annual bonus, with only five companies in the FTSE 100 currently incorporating them into their annual bonus plan for 2019, with an average weighting of 8.2%
- Companies in sectors outside of Energy and Basic Materials, have a lower weighting (in the range of 3-5% per measure)

In the LTIP

- Decarbonisation measures are more common in the LTIP – eight companies in the FTSE 100 have a decarbonisation goal within their long-term plan. The weighting in the LTIP is also higher – 9.3% (across 8 users)
- The preference for use of the LTIP for decarbonisation measures most likely reflects the long-term nature of the energy transition and that it would be challenging to make a material dent in emissions in any one year timeframe. The investments and changes needed to deliver the energy transition are long-term – and so demand long-term targets
- In most cases, where decarbonisation has to date been considered sufficiently material to be included in pay (i.e. predominantly in the extractive industries and other high emission sectors) it poses a long-term risk of asset stranding for investors, who may therefore want to see a long-term link in executive pay



Section 3

Hitting the target or missing the point: how should pay be linked to ESG?

The pay question

We're taking it as a given that boards should integrate sustainability into their business strategy and operating practices. The question is whether, given the importance of ESG, it should be linked to executive pay, and if so how.

Can there even be an argument? ESG represents important outcomes we want to achieve. We get what we pay for. Therefore, we need to include ESG targets in the pay of executives.

But it's not so simple. We'll see that in some cases pay is best aligned with ESG by reforming pay structures rather than adding ESG targets. In other cases ESG targets will play an important role. Academic evidence doesn't provide unequivocal answers to the issues raised but can provide insight, which we'll draw out along the way.

There are two broad schools of thought that are evident in public discourse on the issue, one based on the idea that ESG is aligned with shareholder value, the other that it isn't (see box).

The Alignment View

Companies do well by doing good: there is no trade-off between ESG and long-term shareholder value. ESG metrics are needed to stop short sighted executives (incentivised by short sighted pay plans) pursuing short term profits rather than taking the decisions that are in the long-term interest of their company. ESG metrics are needed precisely because ESG supports shareholder value.

The Trade-off View

Companies extract value by incurring unaccounted for environmental and social costs. There are trade-offs between profit and ESG that need to be made prominent in executive decision making. Only by introducing balance into how executives are paid can we ensure that ESG considerations hold their ground against strong incentives to pursue shareholder value. ESG targets are needed precisely because ESG is in conflict with shareholder value.

The two views often appear to be held simultaneously by the same person – where humans go, cognitive dissonance is never far behind. But there are important differences in the implications for the approach taken, and who gets to decide:

- If ESG is aligned with long-term shareholder value, then why do we need ESG targets in pay at all? Why isn't rewarding long-term shareholder value enough?
- If ESG isn't aligned with long-term shareholder value, then how does the board decide which ESG factors should be prioritised and how do they secure legitimacy for making that choice?

Performance pay can lead to better outcomes where what we mean by success is clear and can be holistically measured (e.g. long-term shareholder value). But in areas where measurement is complex and multi-dimensional, we often eschew incentive pay, for good reason. Think research, education, health.

Business leaders, like most people, are strongly intrinsically motivated. Research shows that the mere act of making commitments, setting targets, and opening ourselves to scrutiny through reporting and measurement can create strong incentives for change even without any financial incentives[1]. Moreover, research specific to CEO pay finds that both directors and investors view intrinsic motivation and personal reputation as more important than financial incentives when setting pay for executives[2]. Of course, paying for ESG can add to those incentives, but with three potential risks:

- First, the risk that the intrinsic motivation of the ESG goals is crowded out by the extrinsic motivation of the incentive. Executives become motivated to hit the goals to increase their bonus, rather than because they believe that doing so is the right thing to do
- Second, the risk that flawed and incomplete ESG targets fail to capture the full extent of the ESG goal. Without incentives, the executives would have been intrinsically motivated to deliver ESG performance; with incentives, they may focus more on the targets in the incentive plan, lessening progress on the wider goal
- Third, executives view pay as unfair if they have delivered strong ESG performance but not been rewarded since the incentive measures the wrong factors

So if we take the view that ESG is aligned with long-term shareholder value, then perhaps the answer is to make pay more long-term, rather than to introduce more metrics. This is where we'll start. We'll then come onto the cases where this may not be enough.

1. Klein et al 1990, Gollwitzerand Brandstatter 1997
2. Edmans, Gosling, and Jenter, 2021

Reforming pay structures to align with ESG

In many cases boards see a focus on ESG factors as critical to supporting long-term sustainable value creation. If this is the case, then it raises the question: why isn't rewarding long-term sustainable value creation the best way to incorporate ESG into pay?

There's more much more alignment than commonly assumed between shareholder value, measured over the long-enough term, and ESG outcomes for other stakeholders. This body of research is well-documented in the book Grow the Pie: How Great Companies Deliver Both Purpose and Profit by Alex Edmans, Professor of Finance at London Business School.

To pick just one example, Edmans (2011, 2012) has shown in his own research how treating employees well pays off for shareholders. More generally, Mozaffar Khan, George Serafeim, and Aaron Yoon (2016) have shown that better accounting performance and higher returns arise for companies that invest in material stakeholder dimensions.

If there is more alignment than trade-off between ESG and long-term shareholder value, then perhaps the problem with executive pay is not the lack of ESG metrics but rather the misalignment between pay and long-term value creation. This is broadly the argument that Edmans makes in Chapter 5 of his book. And it is supported by two strands of argument.

Lengthening the time horizon of pay creates better alignment with ESG. Research[3] suggests that intangible investments like employee engagement and R&D may take up to five years to be fully priced in by the market. This gap between action and reward in the share price goes beyond the timeframe of many executive incentives, which are measured based on performance targets set over one to three years.

Case Study – Natwest Group LTIP

In 2017 Natwest Group introduced a new remuneration policy with no annual bonus, the only incentive plan being a long-term award of shares released to the executive on a phased basis over 4 to 8 years. The shares are subject to a performance test prior to award and a sustainability test prior to vesting. However, the primary performance alignment comes from the long-term evolution of the share price, including after the executive leaves employment. Introducing the plan, the Chair of the Remuneration Committee, Sir Sandie Crombie, said: "The proposed policy … has two principal aims: to achieve greater alignment with shareholders and to discourage the potential for excessive risk taking."

Direct support for this idea is provided by the research of Caroline Flammer and Pratima Bansal (2017). They found a causal relationship between lengthening the time horizon of pay and increases in firm value and operating performance over the long-term – as well as an increase in firms' investments in innovation and stakeholder relationships.

Too much focus on performance targets measured over short periods distorts decision-making. There are multiple studies that show that executive incentives work – just not always in the manner anticipated. Summaries of that evidence can be found in Chapter 5 of Edmans' book and elsewhere[4]. Targets can be part of the problem, not part of the solution.

Overall this suggests that reforming pay structures by making them longer term and lessening reliance on shorter term performance targets – in other words restricted stock – could be the first port of call for boards seeking to improve alignment between CEO incentives and longer term ESG considerations. It also avoids many of the practical difficulties with ESG metrics, which we'll return to later.

In brief – Reforming pay to align with ESG

- ESG and shareholder value are strongly aligned over the long-term
- ESG can therefore be incentivised by lengthening the time horizon of pay
- Performance conditions distort decision making
- Use of restricted stock creates natural ESG alignment

But in some cases reform of pay structures won't be enough. We turn to these now.

3. Alex Edmans (2011), Alex Edmans, Vivian Fang, and Katharina Lewellen (2017) and Sanjeev Bhojraj, Paul Hribar, Marc Picconi, and John McInnis (2009)

4. The Purposeful Company Executive Remuneration Report (2017), Appendix A of the Department of Business Energy and Industrial Strategy Report into Share Repurchases, Executive Pay, and Investment (2019).

Using metrics to align pay with ESG

There are two main sets of reasons for including ESG metrics in CEO pay. First, even if we believe there is strong alignment between ESG and long-term shareholder value, there may be cases where the approach of aligning incentives by lengthening the time horizon of pay and using restricted stock doesn't work. Second, shareholder value isn't always the only goal.

We'll start with the first of these and then return to the second.

When lengthening and simplifying pay isn't enough

ESG targets in pay can communicate priorities and commitment externally to stakeholders as well as internally to employees. Robert Eccles, Ioannis Ioannou and George Serafeim (2014) found that firms that adopted a comprehensive range of sustainability policies were subsequently 2 to 3x more likely to include ESG targets in executive pay. Causality was not established, but it suggests that these firms may have used executive pay as a reinforcement mechanism for sustainability policies. Isabella Grabner, Annelies Renders, and Lu Yang (2020) find that ESG disclosures and ESG metrics in pay are most commonly used to signal commitment where firms have, in practice, strong commitment to ESG but weaker external credibility. Companies may use ESG targets in pay to signal the need to make a step change and to mobilise the organisation.

The long-term share price is a less potent incentive further down the business. Below the executive committee, the influence on, and salience of, the share price is much less. Managers will inevitably have a significant component of incentives based on short term financial and operating metrics relating to their area of responsibility. ESG metrics can act as a counterbalance to these to create a long-term focus in incentives. If managers through the company are rewarded based on ESG, simple fairness considerations may suggest applying the metrics to board executives as well.

Certain long-term ESG factors may take too long to show up in the share price. The market isn't always immediately efficient. As described above it can take five years for intangible investments in employee engagement and R&D to show up in the share price. Some factors such as the success of energy transition for an Oil Major may take even longer. Ideally CEO pay would always be long-enough term to capture the timeframe over which ESG and shareholder value are aligned. In practice this may not always be possible. In such circumstances ESG metrics may be necessary to bridge the gap.

Case study – Royal Dutch Shell climate targets

Following their announcement at the end of 2017 of a strategy to reduce their Net Carbon Footprint, Shell followed this up with inclusion of associated targets in their long-term incentive plan from 2019. It may be that, as an Oil Major, Shell felt compelled to demonstrate to sceptical stakeholders their commitment to the new strategy through pay targets as well as enhanced disclosure around net carbon footprint. Incorporation of targets across senior management incentives also helped to signal internally that the priorities of the company were evolving.

Case Study – BP strategy

BP CEO Bernard Looney announced a new strategy for the company during 2020: “We are setting out a new strategy that will see us pivot from being an international oil company focused on producing resources to an integrated energy company focused on delivering solutions for customers”. The strategy saw a significant shift in capital expenditure towards low carbon energy and electrification, away from traditional fossil fuels. In the medium term BP’s share price and performance will continue to be dominated by the legacy fossil fuels business. Introducing a 30% weighting in the LTIP relating to low carbon and the energy transition adds immediate salience for managers as well as communicating intent to stakeholders.

ESG factors may affect tail risk or licence to operate. What if ESG shows up as a rare but cataclysmic tail event? Turning a blind eye to tail risks can help with shareholder value creation for a surprisingly long time, creating perverse incentives for executives. But when the tail risk bites it bites hard. Think excessive risk taking in the banking industry pre-2008, Deepwater Horizon, ethical scandals such as Dieselgate and LIBOR, revelations about apparel supply chain working conditions. Including appropriate ESG in pay can rebalance incentives to ensure that high-impact low-probability factors are taken into account.

Case Study – health & safety in the resources industry

Cutting corners on safety can increase profits for a while, perhaps for a long time. But there is a moral imperative to protect workers. Moreover, a rare but severe major incident can create material and long-term damage to the company and its licence to operate, in addition to the harm caused to employees. For these reasons pay metrics linked to health and safety risk reduction are a standard feature in high risk industries.

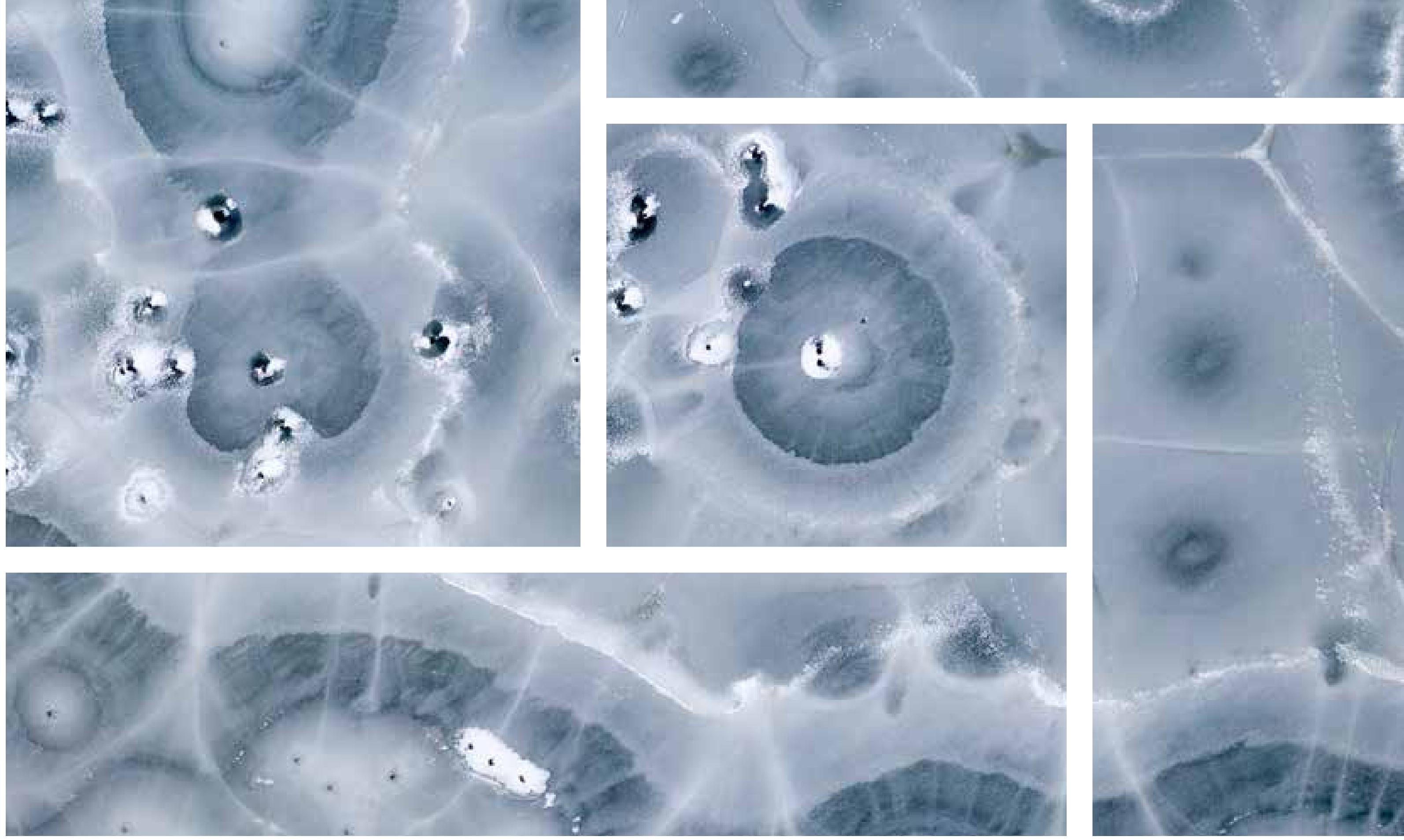
ESG factors provide information on the how as well as the what. The informativeness principle developed by Bengt Holmstrom (1979) states that in a world of imperfect information additional information about how the CEO is going about creating value can improve the incentive contract. ESG targets can provide comfort that the executive’s efforts to improve profits are sustainable rather than taking short-cuts.

It should be noted that Holmstrom’s work suggests that the contract should include all possible additional information, not just ESG. A recipe for unmanageable complexity.

ESG factors may lack salience for the executive given the significant focus within incentives and from the market on short-term profit. Incorporating ESG metrics can create a counterbalance. This will be particularly important when, for whatever reason, the company retains a conventional CEO package based on performance measures over one to three years. Caroline Flammer, Bryan Hong, and Dylan Minor (2019) find that adoption of ESG metrics in pay is associated with: an increase in long-term orientation, firm value, and ESG initiatives. However, the research design just found correlation not causation. It may be that firms with long-term orientation that were more focussed on ESG investments and activities were more likely to include ESG targets in pay, rather than the other way round.

In brief – Reasons for including ESG targets to align with shareholder value

- ESG targets communicate priorities and commitment and can help mobilise the organisation
- The long-term share price is a less potent incentive further down the business
- ESG factors may take too long to turn up in the share price – beyond the realistic timeframe of incentives created by restricted stock
- ESG factors may relate to low-probability high-impact tail risk or licence to operate
- ESG targets may give useful information on how executives have hit financial targets
- ESG may lack salience for executives compared with other factors – introducing ESG targets into pay can address this



When shareholder value is not the only game in town

Now we’re entering controversial territory. How can it be legitimate to pursue ESG goals that aren’t in the service of long-term shareholder value? This is a question that goes to the heart of the debate on so-called “stakeholder capitalism” and what it really means.

This is a topic on which readers will have different views, and it’s not the purpose of this report to weigh the arguments definitively. But what we do aim to do is to consider the cases in which boards might support use of ESG measures other than in support of shareholder value. This will provide insight into how ESG metrics could be incorporated into pay in such circumstances. We see three.

Reasons other than shareholder value for including ESG targets

1. Companies may want to demonstrate understanding of societal expectations.
2. Shareholders may have preferences that are not reflected simply in financial shareholder value creation.
3. Adopting an ESG goal may be a ‘litmus test’ for a company’s purpose that is so important that targets need to be set to reflect this even if the shareholder value implications are ambiguous, or even potentially negative.

We consider each in turn below.

Societal expectations

The rules of the game extend beyond the law. Milton Friedman wrote that the social responsibility of business is to increase its profits provided it stays within the “rules of the game”, which include social norms and moral considerations. Business operates within a social context and social context goes beyond the law. As individuals we constrain our behaviour in many circumstances within boundaries that are far inside the limits of the law. We’d be left with few friends if we didn’t. Business is no different.

Societal expectations are expressed in codes of practice, like the UK Corporate Governance Code, and through professional codes and training. Business also needs to anticipate changing expectations and laws and rules that may come in future as well as those that are here today. Cases relating to drug pricing and distribution, personal data usage, and treatment of workers show that today’s controversy can become tomorrow’s reputational calamity or government intervention. So business has an interest in showing that it ‘gets it’ on the big issues of the day, whether climate, diversity, supply chain standards and so on. ‘Doing the right thing’ as a corporate citizen matters.

This is a complex area for companies. One person's essential priority is another person's politically correct hobby-horse. Societal expectations are dynamic. Companies can't get too far ahead of the political process, as boards don't have political legitimacy. We've seen examples of the hot water that companies can get into when setting themselves up as judge and jury in a polarised society. At the same time, leadership matters and business action can create the context in which political change becomes easier. Visionary business leadership can create coalitions of investors, suppliers, customers and employees that can help shift the Overton window. We've seen this, for example, in voluntary action on climate change. Different companies will have a different appetite for how early to catch the wave of emerging issues, depending on how the issue interacts with their own stakeholders' preferences.

Case Study – Women in Finance Charter

The under-representation of women in senior positions in the Financial Services industry has been coming under increasing political scrutiny for a number of years. The Treasury sponsored the Women in Finance Charter, encouraging firms to sign-up. Signatories committed to include diversity targets in pay.

It could be argued that pushing hard for greater diversity is aligned with shareholder value, and the needs of an organisation in a modern recruitment market. But based on the most rigorous evidence to date you can make the argument both ways, particularly regarding the pace and form of change. And by itself the economic case wasn't promoting rapid change.

More importantly, accelerating fair access to opportunities is simply the right thing to do, and it became clear to the industry that there was strong political and societal support for change independent of the economic case. Including diversity targets in pay becomes a way of focussing leadership attention on the issue. But it also became a way of signalling to society that the industry was determined to change.

Shareholder welfare not shareholder value

It has long been recognised that **shareholders may have preferences that extend beyond shareholder value.** Oliver Hart and Luigi Zingales (2017) have given renewed prominence to this idea advocating a shift from an objective of shareholder value maximisation to shareholder welfare maximisation.

We're seeing ample evidence for such preferences being expressed in the area of climate. It is very difficult for an investor to effectively offset carbon emissions from companies they own. They may prefer companies to act to reduce emissions at source, even if this reduces financial return. Similarly, shareholders may wish to move on issues such as climate, biodiversity, diversity, or labour rights at a faster rate than required by pure financial value maximisation. This might reflect investor wishes for a fairer, more sustainable society.

Case Study – Say on Climate and Say on Purpose

Alex Edmans and Tom Gosling (2020) have set out a proposal for Say on Purpose, also endorsed by The Purposeful Company, which suggests a structured framework for incorporating non-financial investor preferences into corporate decision making. The idea is that investors would have a periodic non-binding vote on a company's articulation of its purpose and actions to fulfil that, allowing investor preferences to be expressed through a process of dialogue with the board. Aena's and Unilever's adoption of a shareholder vote for its climate action plan is an example of this approach on a specific issue.

Where companies are pursuing ESG issues that relate to shareholder welfare, incorporation into executive pay can be beneficial. First, the infrastructure of say-on-pay voting, which is now widespread, makes use of an established mechanism for investors making their views known on the ESG targets adopted, the level of stretch, and weighting versus financial goals. While in principle such issues might better be dealt with at a strategic level through use of Say on Purpose or Say on Climate, until such an approach becomes widespread, use of pay as a negotiation context between companies and shareholders makes some sense. Cevian's recent push for ESG targets to be included in executive pay follows this logic.

Case Study – Climate Action 100+

Climate Action 100+ is a coalition of asset owners and investors who are pushing the world's major carbon emitters to commit to: enhanced governance and disclosure related to climate change and Paris-aligned reductions in greenhouse gas emissions across the value chain. The group is not yet pushing for targets to be included in executive pay, although a number of its members have done so.

Climate Action 100+ articulate the business case for their action in relation to the impact of climate change across the economy and society as a whole as opposed to the impact on the specific companies they engage with. This can therefore be seen as an action that relates to shareholder welfare as opposed to maximising shareholder value within the specific company involved.

Litmus tests for purpose and values

An ESG activity may be a litmus test for the company's purpose and values. Purpose describes how a company benefits society while creating value. Purpose can be helpful in creating a shared understanding between a company and all its stakeholders about how it will behave and interact with the world. It can help investors understand how trade-offs between different stakeholders will be undertaken. This can help the organisation to attract investors, customers, and employees that align with its culture and values. Such consistency of behaviour may have long-term benefits in terms of shareholder value, but such benefits are uncertain in size and timing.

Companies will measure and report on targets relating to litmus tests. For many this will be enough to create the required motivation. But in some cases there may be a benefit in linking litmus tests to pay.

Case Study – Unilever's Sustainable Living Plan

Unilever's Sustainable Living Plan may have elements of a litmus test. Unilever's purpose of making sustainable living commonplace is also closely related with how it creates shareholder value. But the extent of commitments in the USLP cannot always be directly linked to shareholder value enhancements, but go beyond this to be a statement of values about how the firm treats its stakeholders. Incorporation of the USLP as 25% of the company's long-term incentive plan is therefore a powerful statement of intent about the type of company that Unilever is, and provides a point of transparency and dialogue with investors about the significance of its purpose of "making sustainable living commonplace".

In brief – Including ESG targets regardless of shareholder value

- Societal expectations may create non-legal ‘rules of acceptable behaviour’
- ESG targets in pay can incentivise executives to maximise shareholder value subject to these rules
- Shareholders may have preferences that extend beyond financial value, especially where companies can take action it’s hard for investors to take themselves
- Where these preferences are clear, companies may wish to introduce targets to incentivise executives to balance financial and non-financial shareholder objectives
- A company’s purpose represents its social contract with stakeholders, which has enduring value beyond immediate financial considerations
- Where an ESG action represents a purpose ‘litmus test’ companies may want to include it in pay to ensure executives are fairly rewarded and incentivised

Practical challenges

We’ve discussed the situations where it may be appropriate to include ESG metrics in pay, rather than just reforming its structure. But we need to be aware of the practical challenges that face us along the way. These challenges are significant and in some cases companies may legitimately decide that including ESG targets in pay isn’t the right ting to do.

Even if quantitative measures are available, it may not be clear which to use. The range and divergence of ESG scores provided by rating agencies show the difficulties of coming up with ESG measures that everyone agrees on (see for example Berg et al., 2020). Given the complex and qualitative nature of many ESG goals, purely quantitative targets may unhelpfully narrow the frame. Deciding which ESG factors to include and at what weightings is far from straightforward.

Targets can be hit while the goal is missed. There is significant evidence that financial targets can cause short-term actions to hit those targets. (See for example Bennett et al 2017, Edmans and Gabaix, 2016, Bhojraj et al, 2009.) This could also be the case in relation to ESG targets. Steven Kerr’s 2017 article “on the folly of rewarding A while hoping for B” gives multiple examples of how getting incentive targets wrong can undermine the outcome intended. How could that work with ESG? Take as an example gender diversity targets for boards, which some have argued should be included in pay plans. While publicly announced targets might be a great spur to action, including them in pay could risk a focus on a single dimension of diversity at the expense of others, for example ethnic or cognitive diversity. Or it could encourage a singular focus on board gender diversity, taking resources from the arguably much more important dimension of senior management gender diversity. Indeed Georgeac and Rattan (2019) found that demonstrating progress in gender diversity in top leadership positions actually lessened concern felt about gender inequality more broadly. In a similar way it could be that an oil company demonstrating progress in reducing its Scope 1 and 2 emissions may lessen concern about it’s much more material Scope 3 impact.

ESG targets in pay can distract focus from other important dimensions. Bengt Holmstrom and Paul Milgrom (1991) show how in the multi-tasking context faced by CEOs, including targets in the CEO’s incentives can reduce focus on other targets that aren’t represented. This may be particularly significant if there are many ESG dimensions that are material for a firm. Alex Edmans (2021) shows that excessive focus on what is measured may also extend to shareholders. Presented with increasing amounts of quantitative ESG data and targets, there’s a risk that investors ignore the more nuanced assessment of sustainability performance overall.

ESG targets are difficult to calibrate. Pay outs from strategic and non-financial KPIs in bonus and LTIPs are markedly higher (by around 10%–points on average) than from their more objective financial counterparts. More ESG targets in pay may just mean more pay. Even if sensible targets can be set at the point of grant of an award, by the time performance is tested, the world may well have moved on, making the original target, or even metric, irrelevant.

ESG targets add yet more complexity to executive pay. Adding ESG targets to already multi-dimensional packages adds another layer of complexity with all the unintended consequences that may arise.

These challenges aren’t always insurmountable, but they’re significant. Where ESG targets are used the challenges need to be acknowledged and addressed. The issues will be more manageable where companies have one or two objectively measurable ESG priorities that are clearly more material than any others. Where there are multiple ESG priorities it is much more difficult to get right. Given the evidence that ESG and long-term shareholder value outcomes are to a significant degree aligned, the simpler alternative shouldn’t automatically be rejected: improving the alignment between executive pay and ESG by: lengthening the time horizon of pay; and using simpler restricted stock plans. Sometimes pursuit of the perfect is the enemy of the good.

In brief – Practical challenges

- Even if quantitative ESG targets are available it may not be clear which to use
- Targets may be hit while the ESG goal is missed
- ESG targets in pay can distract focus from other important dimensions
- ESG targets are difficult to calibrate and assess
- ESG targets add yet more complexity to executive pay

In this chapter we’ve identified the different motivations for linking executive pay to ESG: shareholder value, shareholder welfare, societal expectations, and purpose litmus tests.

Where the primary motivation of pursuing ESG activity is creation of long-term shareholder value, then including ESG targets in pay may not be the best approach. Instead, there’s a case for lengthening the time horizon of pay and lessening the focus on short-term targets in order to take advantage of the natural alignment between ESG and the long-term share price. When this design change isn’t possible, or wouldn’t be effective, then including ESG targets in pay can create the necessary balance in executive incentives.

There may be cases where shareholder value maximisation is not the primary motivation for an ESG activity. This is both obvious and controversial. Increasingly the discourse on ESG seeks to sweep the issue of potential trade-offs under the carpet, which does a disservice to the quality of debate. We’ve identified three cases where ESG targets might be pursued despite ambiguous or negative shareholder value implications. These are: to meet evolving societal expectations; to meet shareholder goals beyond financial value; and where the action represents a litmus test for the company’s purpose. Where one of these justifications applies, it is particularly important for boards to understand any trade-offs and to ensure that any ESG target is implemented with maximum effectiveness to minimise costs to shareholder value.

Moreover, boards should consider whether adding ESG to pay, given the practical challenges, is significantly better than publicly announcing and reporting on targets. This can provide accountability, while better allowing for the nuance and complexity of ESG issues.

Section 4

A framework for deciding whether to use ESG metrics in pay

In this section we're going to draw together the insight from the report so far, to present a framework of questions for boards to help decide whether to use ESG metrics in pay, and if so, which ones. Before presenting the framework, it will be useful to have two evaluation frameworks for ESG measures. The first applies where the motivation for introducing ESG is to support shareholder value. The second has particular relevance when societal expectations, shareholder preferences, or purpose litmus tests are the driving consideration.

Evaluating ESG metrics in support of shareholder value

In many cases the rationale for including ESG metrics is to provide stepping stones towards long-term shareholder value. Indeed this is the starting point of many investors.

Investor View: The Investment Association

The Investment Association has provided guidance on selection of ESG metrics, emphasising alignment to strategy:

"ESG measures should be material to the business and quantifiable. In each case, the link to strategy and method of performance measurement should be clearly explained."

"...companies are incorporating the management of material ESG risks and opportunities into their long term strategy. In these cases it is appropriate that remuneration committees consider the management of these material ESG risks as performance conditions in the company's variable remuneration. As with any other performance condition, it is imperative they are clearly linked to the implementation of the company's strategy."

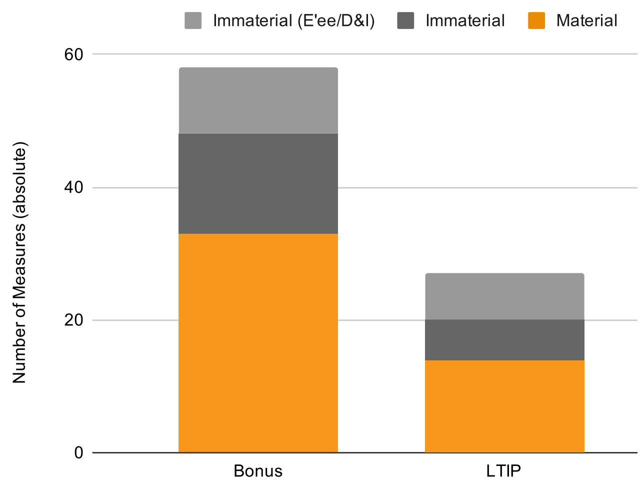
Academic evidence can come to our aid when looking at the metrics that do create this link. Mozaffar Khan, George Serafeim, and Aaron Yoon (2016) have undertaken careful analysis to identify which aspects of ESG do indeed improve shareholder value. They find that firms which outperform on material sustainability issues identified under the SASB Materiality Map® outperform both in terms of enhanced shareholder returns and accounting performance. Importantly their findings indicate that a scattergun approach to ESG will not support long-term shareholder value. Instead, where ESG metrics are used to support shareholder value they should be chosen from those factors identified as material to the company, with evidence showing that the SASB framework is a good starting point for assessing materiality.

The SASB framework

The Sustainability Accounting Standards Board has produced a Materiality Map® of the sustainability issues that are likely to affect the financial condition or operating performance of companies within an industry. Issues are organised under the headings of Environment, Social Capital, Human Capital, Business Model & Innovation, and Leadership & Governance. The framework identifies, by industry, sustainability issues under each heading that are likely to be material to companies in that industry.

https://materiality.sasb.org

We mapped current measures used by FTSE 100 companies against the SASB Materiality Map® and determined that approximately 55% were material according to that framework.



The majority of 'immaterial' metrics are accounted for by employee engagement and D&I plans (shown by the light grey on the chart) particularly in financial services. As highlighted in an earlier case study in this report, the Women in Finance Charter led to much increased adoption of D&I metrics in banks, asset managers, and insurers in the UK market over the last two years. There will be differing views as to whether these metrics reflect societal expectations or an updated view of what is material.

It is striking that nearly half of ESG measures used in pay are not deemed material under the SASB framework. It may be that the SASB framework has not caught up with factors now deemed by boards to be material. Or it may be that boards are frequently including ESG targets for reasons other than long-term shareholder value maximisation. The SASB framework is one that in aggregate is empirically well-supported. However, it is also the result of a consensus process among a number of stakeholders. Accordingly, some metrics deemed immaterial by SASB may be identified as material by a given board based on their own company's strategy.

Evaluating ESG metrics beyond shareholder value

If the shareholder value impacts are ambiguous (but societal expectations, shareholder welfare benefits or alignment with core purpose are not) then linking executive pay to relevant ESG metrics may be an important part of ensuring the CEO's incentives are correctly set. But how should metrics be chosen in this instance?

When looking at ESG metrics through a value-maximising lens, the SASB framework provides a useful tool for selection of appropriate ESG metrics. But what about value-ambiguous cases? Building on the work of Alex Edmans, as laid out in Chapter 3 of his book Grow the Pie, we can outline the following decision rules based on purpose and values, materiality, multiplication, and comparative advantage, for identifying measures that may be appropriate.

Decision-rules for ESG metrics that have an ambiguous impact on value

Purpose and Values

The measure should reflect the company's purpose and values, so as to act as a reinforcement of the relationship and implied contract between a company and its stakeholders, including shareholders and wider society. Ideally shareholders would have had a say on the purpose and associated stakeholder priorities.

Materiality

The measure should relate to a material stakeholder, so the value created is more likely to flow back to profits in future.

Multiplication

The measure should be multiplicative, meaning that the stakeholder value created exceeds the cost. This is not always easy to quantify. But it is most likely to be the case when the stakeholder impact is not easily separable from the company, meaning that the company is much better placed than shareholders themselves to ensure a given ESG outcome.

Comparative Advantage

The company should have a comparative advantage in the measure being adopted. That is, the company should have skills, resources, or capabilities that make it better suited than other parties to carry out the action.

This framework ensures that, where shareholder value is not the goal, a rigorous selection process is used to ensure measures that maximise stakeholder value. We've seen that shareholder value is only enhanced by focussing on material ESG factors. In the same way, stakeholder value is maximised by companies focussing on those ESG factors that are aligned with the company's purpose and the principles of multiplication, materiality, and comparative advantage.

Questions for boards

We're now in a position to draw together the discussion so far to come up with a set of questions for boards to consider when considering whether to introduce ESG targets into executive pay, and which targets to use if they do so.

Question 1: Why are we considering including ESG targets in pay?

What objective are we seeking to support?	☐ Shareholder value? ☐ Shareholder preferences? ☐ Societal expectations? ☐ Purpose litmus test?
Are existing incentives incomplete or insufficient?	☐ Is there a potential trade-off between measures and ESG? ☐ Are existing incentives too short term to capture the ESG priority? ☐ Is intrinsic motivation to pursue the priority insufficient?
Have alternatives to including ESG targets in pay been considered and rejected?	☐ Change incentives to long-term restricted stock? ☐ Rely on long-term shareholding requirements to create alignment with ESG? ☐ Publicly announce and report on targets to create incentive and accountability?
Are there other benefits to including ESG in pay that we need to take into account?	☐ Do we need to demonstrate commitment and priorities to stakeholders? ☐ Are we trying to create a more effective incentive for wider management to mobilise the organisation? ☐ Is there an ESG tail risk we are addressing that may not be reflected in existing measures? ☐ Do we need to create salience for the ESG priority given noise affecting the share price?

Question 2: Are our chosen ESG measures aligned with strategy and focussed on the big issues?

Are the ESG measures aligned to a strategic priority?	☐ Do we already use and report on the measure? ☐ Is the measure clearly aligned to business strategy? ☐ Do we have clear data on shareholder preferences or societal expectations, if these are our motivation? ☐ Is the ESG objective a critical aspect of our purpose?
Do the ESG measures reflect material issues that require a step change in performance?	☐ For shareholder value: is it material according to the SASB Materiality Map®? ☐ For other motivations: does it satisfy the principles of materiality, multiplication, and comparative advantage? ☐ Is the measure one of a small number of ESG measures that are clearly first amongst equals, requiring a step change in performance?
Can we set appropriate stretch?	☐ Do we have data to enable us to set minimum expectations and a stretch target? ☐ Can we ensure that the target will not be seen as a "soft option"?
Are there clear and assured measurement criteria?	☐ Is the measure simple and understandable for all parties? ☐ Will shareholders and other stakeholders accept that meeting the measure means the ESG objective is met? ☐ Can the measure be subject to independent assurance?

Question 3: Have we considered and mitigated the risks of including ESG targets in pay?

Can we measure the ESG priority we want to support?	☐ Are there quantitative measures that can be used? ☐ Is there reasonable consensus about these measures? ☐ Is the data readily available and of high quality?
Do the measures capture the ESG priority completely enough?	☐ What risk is there that we hit the target while failing to meet the intent of the measure? ☐ Are we capturing important qualitative as well as quantitative aspects? ☐ Could outcomes be perceived as unfair by executives?
Can we avoid distorting incentives?	☐ Do we risk undermining intrinsic motivation? ☐ How would we feel if this target was hit at the expense of other priorities that are not included in incentives? ☐ How might the target encourage behaviour that is inconsistent with the ESG goal?
Can we keep our pay plan simple enough?	☐ Can we measure the ESG objectives in a sufficiently simple way? ☐ Will we have to include multiple ESG metrics or will one or two be sufficient?

Linking pay to ESG is equal parts art and science, and some structured thinking helps ensure the bases are covered. We hope the framework we've presented helps boards chart a path through foggy territory, avoiding mishaps on the way.

We'll now move from theory to practice, to look at ways ESG targets in pay can be implemented in the real world, if that's what you've decided to do.

Section 5

Implementing ESG targets in practice

How to link ESG targets to pay

If a board has decided to include ESG targets in pay, then effective implementation is critical. One of the biggest challenges facing both companies and investors is the lack of any clear guidance on what ‘good’ looks like in an ESG measure. And the truth is, there isn’t a single ‘right’ approach. Each company has its own environmental and social impacts, a different position on the ESG maturity curve and a different prioritisation of ESG issues.

Making it right for your company – the variable dimensions of an ESG metric

In developing the mechanics of an ESG measure, Boards will need to address four sets of design criteria and identify the right approach for the needs of the business. The right approach will vary for different companies and different types of metric.

A. Input vs output

An ESG performance measure can be either input (actions the company will take towards a goal, for example establishing an internal carbon pricing mechanism) or output (direct measurement of the goal itself, for example reduction in greenhouse gas emissions). Output targets are often preferred by investors because of their objectivity and lack of wiggle-room.

This could involve setting a GHG emissions goal or a target level of female representation in senior management. It is easy to see how well a company has performed, and so the justification for the pay level is clear. But focussing on what can be measured can distract focus from the real underlying issues. Addressing senior level female representation directly may be less important than creating gender-blind recruitment and promotion processes, and well designed flexible working and return to work policies through the company.

So there are many situations where an input measure would be more appropriate. But it is imperative that input measures are challenging to deliver and not just tick box exercises. Performance under input measures must be clearly disclosed, with the rationale for the pay out transparently explained.

Case study: Input vs Output

10% of Royal Dutch Shell’s LTIP is an Energy Transition measure, including both input and output goals.

Input Measures are focused on driving future Net Carbon Footprint (‘NCF’) reduction through initiatives such as the growth of the power business, advancement of biofuels and the development of systems to capture and absorb carbon.

The output measure assesses 3 year performance against a Net Carbon Footprint target (Shell’s bespoke emissions measure).

Investor View: Schroders

Schroders have commented on their preference for output measures:

“In formulating proposals, remuneration committees and boards should use financial and ESG metrics for measuring executive performance which focus on outcomes rather than inputs to potential corporate performance.

Investor View: BlackRock’s views on ESG criteria in pay:

“ESG-type criteria should be linked to material issues and they must be quantifiable, transparent and auditable. These criteria should reflect the strategic priorities of the company. For that reason, the inclusion of ESG-indices is generally not considered to be appropriate criteria.”

B. Individual KPI vs scorecard

By picking one or two critical indicators of performance and setting realistic, ambitious targets around these, an incentive is most likely to function effectively. This is generally the best approach when, like in an oil and gas business, there are one or two ESG dimensions that tower above all others.

But many companies have complex interactions with the environment and society, simultaneously having multiple material dimensions of ESG impact. In this case, creating a scorecard of measures will be a sensible path. With a scorecard of measures it is important to not have too many, and it is only the most material KPIs that should be included in pay. It is also useful to ensure the weighting of the scorecard is sufficient so that all components carry an adequate individual importance. But remember, a focus on too narrow a group of measures can distort thinking and distract from other important ESG dimensions.

Case Study: Individual KPI vs scorecard

While Royal Dutch Shell’s LTIP is focussed on the clearly most material KPI of net carbon footprint reduction, Unilever’s sustainable living plan encapsulates a scorecard of sustainability priorities the company has used for a decade now – embedding them internally and communicating them to stakeholders and the market. They operate a scorecard, weighted 25% of the LTIP plan, which measures performance across targets in relation to their Sustainable Living Plan, including health and wellbeing, environmental impact, enhancing livelihoods, transformational change, and ratings and rankings.

C. Annual bonus vs LTIP

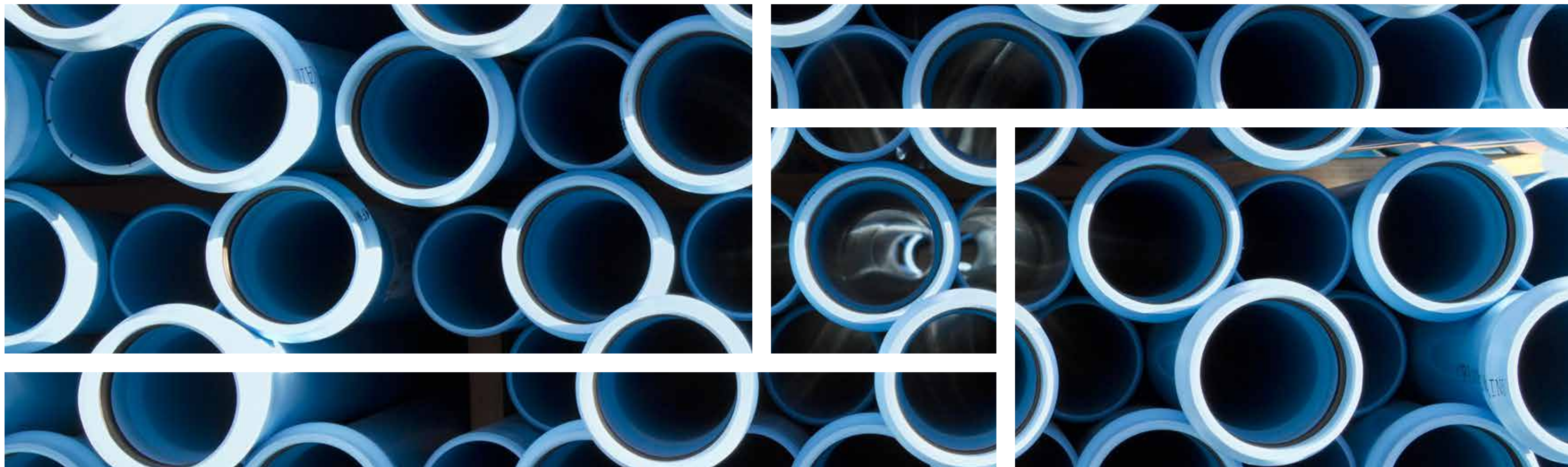
Market practice suggests that the LTIP is the natural home for environmental and sustainability output measures. Reducing carbon emissions is a long-term game for most companies – as are many other environmental and sustainability initiatives which take time to shift the dial, and often demand an operating model transformation. This means they will naturally have long-term targets, and most sensibly form part of the LTIP.

Other objectives will be better suited to the annual bonus – especially those where change can be meaningfully assessed over single year time frames.

Fundamentally the choice of bonus vs. LTIP will come down to the periods over which targets can be rigorously calibrated.

Case Study: Annual bonus vs LTIP

BP uses ESG measures in both the annual bonus and the LTIP. Under the policy introduced in 2020, the bonus will have a 20% weighting on each of safety and environment. Safety goals relate to well-established process safety events and injury frequency rates. Environmental goals relate to short-term emissions reduction targets. The LTIP now contains a 30% weighting to low carbon and the energy transition, reflecting the longer term and more strategic nature of this ESG factor.



D. Underpin vs Scale target

For most ESG goals, 100% achievement is not the expectation. This means that scaled measures, with threshold and maximum performance levels are needed – incorporating ambitious top end ESG targets. This is particularly the case where an ESG metric is linked to a key strategic priority, such as energy transition.

But sometimes, ESG goals are better suited to an underpin. These will more likely be the case when a particular ESG factor is considered a minimum requirement. Health & Safety could fall into this category.

Case study: Underpin vs Scale target

Whilst most ESG measures in the FTSE 100 are scale targets, BT operate a restricted share plan with two **underpins**, one being that there must be ‘No environmental, social or governance issues resulting in material reputational damage’.

Investor View: Legal and General Investment Management

Some shareholders have expressed a specific preference for the use of underpins rather than scale targets for ESG.

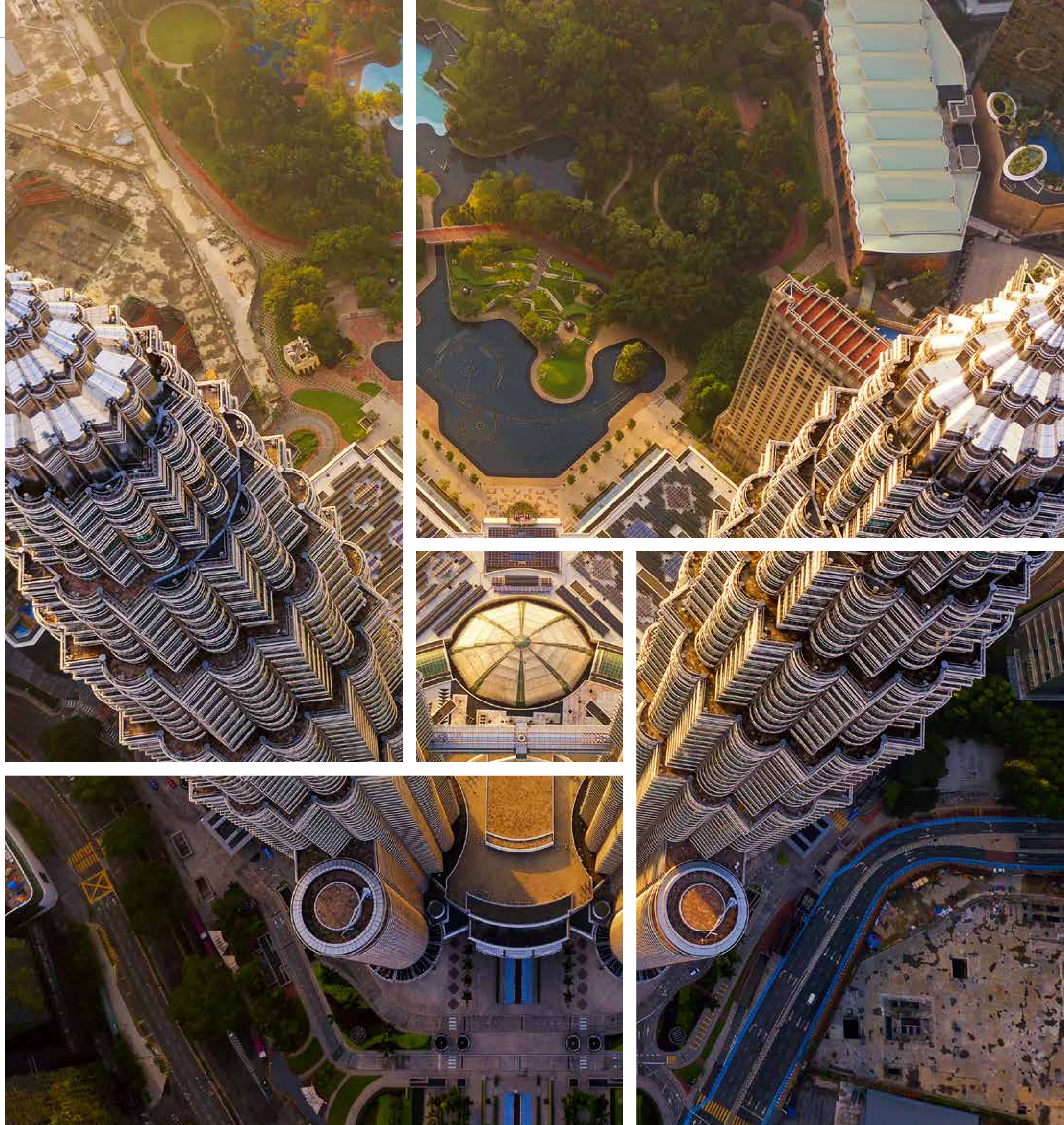
Annual incentive: “Equally, remuneration committees should apply minimum ESG targets as ‘gateway’ or performance moderators to financial performance payouts, to ensure the financial targets are not achieved at the cost of long-term sustainability. We expect companies that are exposed to high levels of reputational risk to include relevant targets that focus management on mitigating these risks”.

LTIP: “Other measures… should also reflect the company’s ESG risks in the form of underpins or reducing provisions where minimum standards are not achieved.”

Investor View: Institutional Shareholder Services

And increasingly investors expect ESG factors be taken into account on a discretionary basis even if there is no formal underpin, as reflected in guidance from **Institutional Shareholder Services**:

“The Remuneration Committee should disclose how it has taken into account any relevant environmental, social and governance (ESG) matters when determining remuneration outcomes. Such factors may include (but are not limited to): workplace fatalities and injuries, significant environment incidents, large or serial fines or sanctions from regulatory bodies and/or significant adverse legal judgement or settlements.”



Section 6

Bringing it together: a case study for the housebuilding industry

In this section we try to bring to life all of the concepts set out in this report. We examine an illustrative case study of Future Build, a mythical company in the housebuilding sector.

Future Build is a high volume housebuilder in the mid to affordable range of the market. Future Build's purpose is "Building a Future for Everyone". The company has suffered from recent reputational challenges relating to onerous terms on new build houses and association with safety issues relating to certain building materials. The health & safety record of the company is behind industry average. The Board has recently established a sustainability committee to oversee an extensive project to identify the various dimensions of the company's environmental footprint including materials sourcing, construction methods and environmental efficiency of built homes. Following recent changes to the Board, one third of Future Build's directors are women.

The Board is facing pressure from stakeholders to include ESG metrics in pay. The Board is undertaking a process of determining whether and how to introduce such metrics. The company has a traditional pay package with bonus and LTIP predominantly based on profit, EPS, and cashflow metrics.

We'll now illustrate how the frameworks from Sections 4 and 5 could be applied to this case.

Question 1. Why are we considering including ESG targets in pay?

Future Build has received representations to include stakeholder metrics from a number of directions:

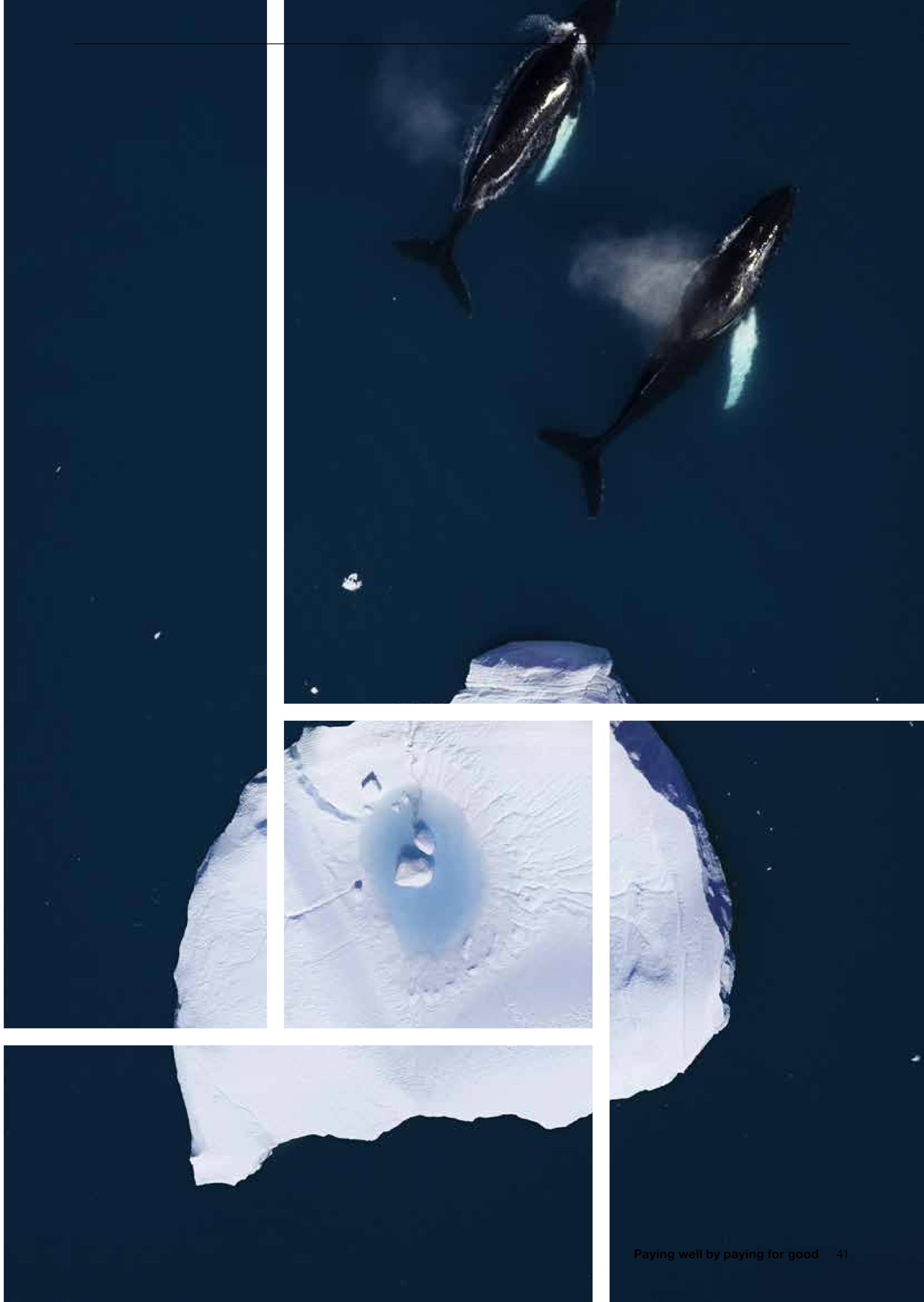
- Investors want to understand how Future Build is taking climate change into account in its strategy. Some investors have directly asked that Future Build include climate goals in executive pay
- The industry has been the subject of political scrutiny, and an MP has written to Future Build criticising them for their poor health & safety record, treatment of workers (in particular not paying a living wage), excessive executive pay, and lack of gender diversity. The MP suggested linking pay to health & safety and diversity targets, saying that this represented clear expectations of a modern society
- Future Build's purpose statement includes references to sustainability and using the company's position as a leading industry employer to make a difference in the area of diversity, particularly to improve representation of women and ethnic minorities in the industry

Therefore, there is a range of potential motivations for including ESG targets in pay. Taking this feedback into account, and following an ESG strategy review by the company to identify key priorities, the Remuneration Committee is considering incorporating the following targets into pay:

- Climate change & sustainability
- Health & safety
- Diversity
- Pay fairness

Future Build has a conventional pay scheme based on traditional financial targets. Future Build's incentives are financially driven, and do not reflect the ESG dimensions in the short term. Therefore the Board believe that balancing incentives may be required.

ESG issues relating to climate change & sustainability have very long timescales – far exceeding incentive timescales and in many cases executive tenure. For example, emissions and the impact of climate considerations on land bank, housing quality issues (e.g. cladding), ecological performance issues and ownership structures (ground rent) may take a decade or more to emerge. ESG issues such as these may fail to manifest in share price within timeframes that are reasonable even for long dated restricted stock plans. Moreover, the Future Build Board believes its current performance share plan model is better aligned to the culture of the business, with a desire for high reward in strong years but an acceptance of lower pay in downcycles, and so prefers not to adopt a restricted stock plan.



There are further benefits to including ESG targets in pay that the Board considers. H&S issues can give rise to tail risks, and Future Build's lag to the industry could start to create reputational and recruitment issues. Given the poor reputational standing of the company, the Board deems it important to signal commitment to ESG issues both externally and internally. Moreover, with a new CEO driving culture change around safety and sustainability, alignment of incentives across the organisation is viewed by the CEO as an important lever for change. In particular, meeting new sustainability standards could harm profitability in the short term, and the CEO wants to balance incentives for managers who may otherwise perceive the strategic change as leading to lower payouts.

Taking all these factors into account, the Future Build Board believes there is a good case for including ESG metrics in pay, and so proceeds to evaluate potential metrics in more detail.

Question 2: Are our chosen ESG measures aligned with strategy and focussed on the big issues?

Climate change and sustainability are key to the future commercial strategy for the business. The Company has also received multiple representations from shareholders, including an anchor shareholder, relating to ensuring Paris-alignment of business strategy. The climate change and sustainability goals therefore reflect key strategic, investor, and societal dimensions.

Health & safety, diversity, and pay fairness all affect important stakeholders. The reputation of the company and industry is in a position that demands improvement, and addressing these issues will play a role in demonstrating that the company is aligned with societal expectations. These issues are also aligned with the stakeholder dimensions of the company's purpose of building a future for everyone.

The Future Build Board tests its thinking by assessing the material ESG issues for the housebuilding sector using the SASB Materiality Map®. According to this framework, the following metrics would be material in the sector.

SASB material category	Potential ESG metrics
Ecological	Green vs brown developments Impact of sites on biodiversity and water stress Environmental litigation Integration of environmental considerations into site selection, design, development and construction
Product design	Sustainable homes – environmental scores and standards, covering materials and usage (e.g. modern methods of construction)
Employee H&S	Fatal and non-fatal injuries RIDDOR* / LTIFR**
Business Model Resilience	Flood zone exposure Climate risks, exposure, resilience and adaptation

*Reporting of Injuries, Diseases, and Dangerous Occurrences Regulations

**Lost Time Injury Frequency Rate

Environment & sustainability and employee health & safety are both material from an investor perspective. Between them these measurement areas account for most of the SASB material ESG dimensions. These are also material issues as expressed in societal expectations, investors preferences, and the company's purpose.

Diversity and fair pay are also a focus of investors and a significant issue in the housebuilding industry, as well as being aligned with the company's purpose. Future Build's position as a leading industry employer can help it to set practices across the industry. However, these factors are not deemed material under the SASB Materiality Map®. Moreover, the company is already significantly more diverse than the industry average, and worker pay and conditions are towards the upper quartile of the market.

Board diversity at Future Build is already ahead of industry peers, and wider company diversity metrics will quickly become multi-dimensional. There is a risk of narrow framing if one metric (e.g. % of women in senior management) is chosen. By itself investor preferences seem unlikely to immediately require inclusion of a pay metric on diversity or fair pay.

Health and safety measures are well established, measurable, auditable, and with a long-enough data series to enable calibration.

Environment & sustainability goals are more challenging. The measures are new and evolving. The Board determines that use of a scorecard approach with qualitative judgement overlay, while adding complexity, will be manageable, and worth it in light of the benefits perceived by the Board in linking this dimension to pay.

The Future Build Board concludes that climate & sustainability and health & safety are the most material priorities that are suitable for inclusion in pay. The Board concludes that diversity and fair pay should be the subject of publicly announced five year targets, with progress towards these disclosed and reported on, as opposed to inclusion in pay.

Question 3: Have we considered and mitigated the risks of including ESG targets in pay?

The chosen measures of environment & sustainability and health & safety have good underpinning measurement frameworks, especially following the Sustainability Committee's work on measuring the company's environmental footprint.

The chosen health & safety metrics have been shown by many years of research in this field to be strong indicators of a robust safety culture, which have been designed to avoid distortions and arbitrary outcomes. The Board is therefore satisfied that use of the two key metrics, RIDDORs and LTIFR, captures the essence of the health and safety objective without adding excessive complexity to the incentive system.

Environment & sustainability is undoubtedly more challenging. The objective is multi-dimensional, with many measurable components. The Board is not so concerned about a focus on this element to the exclusion of others given its over-riding strategic priority. However, there is a concern about the possibility of complexity arising from including multiple KPIs in incentives.

The Future Build Board believes that the risks arising from introducing health & safety and environment & sustainability metrics into pay can be managed, although care will be needed in implementation, especially for environment & sustainability.

How to do it?

The Board considers the four design dimensions for each of the candidate ESG metrics as follows.

Design dimension	Application
Input vs output	There are clear output metrics for health & safety based on RIDDORs and LTIFR. Environment & sustainability measures will need to be a mix of input and output measures. Some measures, such as average sustainability performance of new homes, can be measured on an output basis. Other projects, such as sustainable sourcing initiatives, may be more input in nature.
KPI vs scorecard	Health & safety KPIs can be directly included in incentives given that the Board considers two metrics to be the key indicators. For environment & sustainability the number of dimensions and the mix of input and output measures lends itself to a scorecard approach with some element of judgement in evaluation by the Remuneration Committee. This will also aid simplicity and avoid some of the risks relating to this measure; although the assessment will be based on many targets, these will be evaluated holistically by the Remuneration Committee and with a qualitative overlay. This will also align with Future Build's approach to sustainability reporting.
Annual bonus vs LTIP	Health & safety performance can be targeted, measured, and impacted on a one-year basis and so can be included in annual bonus. Environment & sustainability goals are inherently more long-term with multi-year timescales needed to affect outcomes on some of the dimensions. It is therefore more suited to LTIP.
Underpin vs scale targets	Health and safety is arguably a 'table-stakes' issue, lending itself to penalties as opposed to reward, and therefore an underpin approach. By contrast environment & sustainability goals are integrated into Future Build's growth strategy and so can benefit from use of scale targets.

The decisions of the Future Build Board

The Future Build Board makes the following decisions based on the preceding analysis.

Of course, this is simply an illustrative case study, and the Board could reasonably have come to different conclusions. However, we hope that it helps to illustrate how a structured process can help lead to more robust decision making in this difficult area, helping boards also to explain their decision-making to stakeholders.

Health and Safety	Included as a multiplier that can reduce the annual bonus by up to 20% based on performance against targeted improvement.	A material KPI for shareholder value that also helps reduce tail risks for the company and is aligned with purpose.
Environment and Sustainability	Scorecard of key environment and sustainability KPIs forming a weighting of 15% in the LTIP.	A material KPI for shareholder value that is also aligned with shareholder welfare, societal expectations and purpose.
D&I and Pay Fairness	Not included in pay but retained in the company's sustainability plan and subject to regular reporting.	Important KPIs but complex to include in pay due to their multi-dimensional nature.

Section 7

Conclusion

ESG targets in pay have their place but are no panacea.

When considering whether to incorporate ESG metrics into pay, boards need to ask themselves whether the metric is being included:

- Because the ESG objective supports long-term shareholder value, and the KPI is a stepping stone to that end; or
- Because the ESG objective conflicts with shareholder value, and the KPI is needed to balance executive incentives.

If the motivation for including ESG targets is creation of long-term shareholder value, boards should consider whether other pay reforms, such as simplifying and lengthening the time horizon of pay could achieve the same objective. Alternatively, publicly committing to, and reporting on, ESG goals may create sufficient accountability, while also allowing for the nuance and qualitative nature of many ESG goals. If not, then when including ESG metrics in pay boards need to focus on ESG dimensions that are material to the company. And they should be alert to potential unintended consequences: distorting incentives, hitting the target but missing the point, measurement and calibration challenges.

When incentivising an ESG factor that has an ambiguous or negative impact on shareholder value then boards need to be clear on the justification for their action. Is it to meet shareholders' non-financial preferences? Is it to accord with societal expectations? Is it because the ESG factor represents a litmus test for the company's purpose? If so, how are these being assessed and traded off against shareholders' financial expectations? Shareholders themselves need to be sure that their own clients' views are being faithfully represented and that they understand any trade-offs involved.

In such cases boards need to be sure of the support they have from key constituencies – especially investors. And they need to be sure of the legitimacy of their actions. There's a need for companies to show leadership on the key challenges of our day. At the same time there's a problem of legitimacy if board decision-making strays too far from actions to support long-term shareholder value, without a clear alternative mandate.

Principles of alignment with corporate purpose, materiality, multiplication, and comparative advantage can help identify the ESG factors that are first amongst equals. This will help ensure a focus on the metrics that will make the biggest difference to, and are well understood by, the company and its stakeholders.

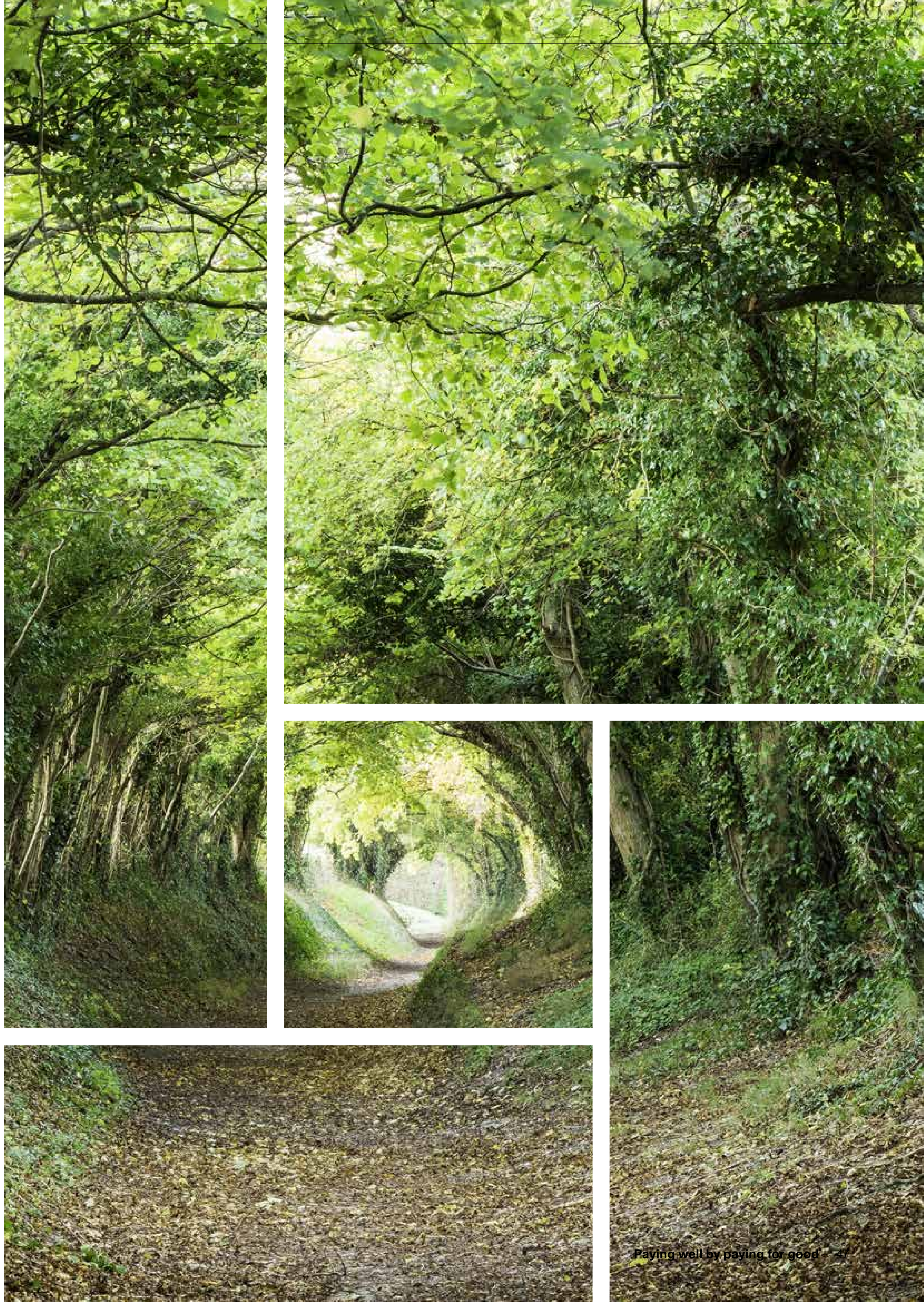
But in implementation the devil is in the detail. Incorporating ESG targets into pay takes boards full square into a world of potential unintended consequences. Using existing measures aligned to strategy. Focussing on the big issues, particularly those requiring a step change. Setting appropriate stretch. Ensuring clear and assured measurement criteria. These are guides to action that can help boards avoid the worst pitfalls.

Regulators, ESG specialists within investors and proxy advisors, and policymakers all need to be alert to the need for nuance in matters ESG. One-size-fits-all, simplistic solutions may do more harm than good. But amongst ESG analysts and pressure groups there are strong incentives to push standardised approaches in the name of comparability. It's vital that boards are allowed to retain discretion to align pay with ESG in a way that is suited to their circumstances. There needs to be recognition that this may or may not imply incorporation of ESG targets.

Incorporating ESG targets into executive pay can play a role in helping some businesses be a force for good in addressing the immense challenges we face today.

But adding ESG to pay is not a simple equation. The answer is not always what we expect, and the risks of getting it wrong are substantial.

Paying for good while paying well is a hard thing to do.



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