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BETTER EXECUTIVE BONUS PLANS FOR ENVIRONMENTAL, SOCIAL AND CORPORATE GOVERNANCE (ESG)

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SRI, CSR, GRI, ESG; Stakeholders, B-Corps, 3BL — what to make of this acronym soup? Thirty years ago, ideas of investing and managing beyond profits and shareholder return for social responsibility were new, aspirational, largely driven by individuals and presumed to come at the cost of making money. Not so anymore. Today, it is generally assumed that what's good for people and sustainable for the planet is also what's good for risk management and sustainable for long-term shareholder return. Now driven as much by doing good as seeking profits, everyone from major institutional investors to retirees knows the smart money is on all manner of socially responsible ways of doing business. The debate in most of the business world is no longer about whether this makes sense, but how best to do it. Executive incentive compensation is now an important part of that. And ESG has emerged as the leading framework for doing it.

In Switzerland, 30% of public companies already have some kind of ESG component in their bonus plans with ESG metrics accounting for 10% to 33% of short-term variable compensation (Hoevenaars 2019). In Germany, it's 21% of public companies (Velte 2019). In the United States, still less than 10% of the 100 largest companies use ESG metrics in their executive incentive plans but that number is rising, and if Europe is any example, with room to grow (Mason and Liao 2015).

Before we go further, let's discuss terminology. Stakeholder is mainly a governance term; B-Corp describes an entity and its mission; CSR (corporate social responsibility) concerns internal business ethics, culture and self-regulation; GRI (global reporting initiative) is a sustainability reporting standard; 3BL (triple bottom line for social, environmental and financial) an accounting method; SRI (socially responsible investing) an investment strategy. ESG is the broadest, most universally applied, consensus standard for both rating agencies and bonus plans.

But from what I see in the market and talking to corporations, most ESG bonus plans are poorly designed, which may be the reason they achieve such mixed results (Maas 2018). While there is discussion of substantive vs. merely symbolic inclusion of ESG criteria in executive compensation, the most recent research doesn't examine various options for the actual ESG performance measurement methods used (Flammer, Hong, and Minor 2019).

What is missing for management purposes is a practical framework of ESG performance measurement alternatives for executive compensation. Russ Miller, founder and CEO of ClearBridge Compensation Group, said, "ESG metrics have gotten a lot of attention for inclusion in incentive plans. But to do that effectively, companies must first have a clear ESG strategy and mechanisms in place to measure success against that strategy" (Mason and Liao 2015).

I propose such a framework. It includes and integrates the common use of ESG targets with the demonstrated advantages (Holmström 2016) of relative performance measurement, the credibility of ESG rating agencies and the judicious use of after-the-fact performance evaluations. I examine the pros and cons of each method, suggest how they may be used together and then consider what I see as the chief obstacle to implementing such a system: corporate politics and internal resistance. I conclude with a recommendation for how this resistance may be overcome and this framework applied.

Table 1 summarizes the advantages and disadvantages of four fundamentally different methods of ESG performance measurement for executive incentive compensation.

ESG TARGETS

Target setting is the most common method used today to measure ESG performance. This method appears straightforward: targets are set in advance (ex ante) and variable remuneration depends on the degree to which they are met. Such targets may be ESG project successes, such as the introduction of GRI reporting, the implementation of training on waste disposal and recycling or the completion of an energy-saving building refurbishment. They may also take the form of

TABLE 1 Pay Communication Decisions and Sample Practices

Methods	Pros	Cons
ESG Targets (Objectives for activities, projects and ESG results set by the company as a goal)	Target setting already needed in management process Tangible (line of sight) *Internally controlled*	Political and costly (internal negotiations) Realistic (instead of challenging) Inflexible (priorities and technologies change) Expression of mistrust (why incentivize a supposedly shared goal?)
ESG Relative Performance Measurement (compared to peers, on the basis of key figures the company considers relevant)	Minimal target negotiation Challenging (outperformance rewarded) Flexible (accounts for new technologies, priorities and economic cycles) Maintains trust and intrinsic motivation; reduces conflict and engenders alignment *Partially internally controlled*	Possible discussion on comparability of metrics and peers Need for data collection and observation of peers Loss of "performance story" authority *Partially externally controlled*
ESG Ratings Agencies (Refinitiv, S&P Trucost¬¬ and RobecoSam, Sustainalytics, ISS ESG, MSCI ESG, Vigeo Eiris, EcoVadis, etc.)	Widely accepted expertise Independent No internal target negotiations	Non-transparent process (competitive industrial and trade secrets) Differences in values and opinion with rating agencies cannot be resolved (e.g., weightings) Static (small incremental changes) *Externally controlled*
ESG Performance Evaluations (internal or independent performance assessment by means of expert opinions, based on internally and externally available objective and subjective facts)	Highly motivating Challenging and flexible (like relative performance measurement) Combined use of other three methods possible *Internally controlled*	Requires trust Requires effort and relevant knowledge Discretionary evaluations are no longer widely accepted (though widely practiced in the past, and still today by privately owned companies)

achieving specific and measurable ESG performance indicators, such as meeting a CO2 reduction goal, exceeding an energy efficiency figure or achieving a target value in accident statistics.

Ex ante targets have two obvious and practical advantages: setting targets is a familiar, regular and essential process that is already happening anyway, and targets contain clear instructions for tangible action. As early as the 1960s, Edwin A. Locke identified target setting as one of the most important tasks in management. Locke (1968) said it seems self-evident to combine these unambiguous targets with remuneration, both to reinforce their importance and to better motivate managers to achieve them.

Unfortunately, this is only a sensible approach at first sight. The apparent benefits of target setting are both undermined and offset by four significant disadvantages. First, as soon as targets become relevant for remuneration, the beneficiary's interests change — and diverge from those of their superiors. Goals are generally the result of extensive planning. It is an internal negotiation process between superiors and subordinates. Because ultimately the issue is compensation, this process becomes political. The employee has a remuneration-relevant interest in characterizing goals as profound challenges. Targets should be presented as being as difficult as possible to achieve so that they can therefore be achieved more reliably. Management has exactly the opposite interest. It is for this reason these budget negotiations have been heavily criticized long before ESG considerations, even famously so, such as in the eye-catching article, "Paying People to Lie" (Jensen 2003). He stated negotiations are both time consuming and politically costly. They foster disingenuity rather than candor, create conflict rather than collaboration and produce incentives that can backfire.

Even if the parties involved somehow manage to negotiate goals honestly, in spite of their own self-interests, the second problem with ESG target setting is that it still tends to produce goals that are merely realistic rather than challenging. By definition, any goal relevant to compensation must also be achievable, i.e. realistic. Realistic goals are average goals, and thus naturally do not motivate managers to achieve the extraordinary. Even well-intentioned, compensation-based targets are inevitably less aspirational than the initial impetus behind the whole ESG enterprise suggests they should be.

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A third disadvantage of ESG measurements is that they are inflexible. Priorities can change, economic cycles may change, technologies will change. But because of their link to compensation, once set, ESG targets cannot be adjusted retroactively.

Finally, compensating for targets replaces intrinsic motivation with extrinsic, and is inherently an expression of mistrust. Why should a manager whose job it is to achieve their targets not already be presumed to faithfully fulfill them? If a bonus is added to this, the beneficiary is informed that without a bonus, their willingness to perform their duty might be called into question. Managerial practices that decrease trust and destroy intrinsic rewards are demotivating and lower performance (Pink 2011).

ESG RELATIVE PERFORMANCE MEASUREMENT

As is also the case with conventional bonus plans, relative performance measurement in ESG bonus plans goes a long way toward alleviating problems associated with ex ante negotiated target setting.

Relative ESG performance measurement solves the negotiation problem because there is no absolute target to negotiate. Instead, one's own performance is simply compared with the performance of peer companies. The more peers a company outperforms, the better the performance of the company — and the higher the bonus. The only two variables to agree on with relative performance plans are the metrics to be measured and the peer companies to be compared to. And both parties should have the same objective: to be as accurate as possible. There may, of course, still be objections and negotiations over the comparability of certain key figures or a particular peer company. Relative performance management is a demanding yardstick that some managers may not want to face. But these tactics are harder to disguise and negotiations are typically far more transparent — and less costly.

The level of aspiration is also a main advantage of relative performance measurement bonus plans. Companies that expect outperformance are frequent users of this method. If these high performers were to compare themselves to their own high targets, their true effective performance would not really shine. This is why outperformers like to compare themselves to the market (Stern 2020). And when they do, there is really no limit to their goals, and also no sandbagging when they exceed them to "bank" performance for next year's bonus. These performance-impeding effects of negotiated targets are eliminated by relative performance measurement, yielding full and sustained effort toward goals that are truly challenging rather than merely average or achievable.

A third advantage of relative performance measurement for ESG is its flexibility in the face of change. Take climate protection. With relative performance measurement, it is not necessary to know in advance what new technologies might be developed to absorb greenhouse gasses (GHG), for example, or how priorities might shift as a result (such as to GHG-absorbing projects). Unexpected changes in the economic cycle can also have an impact on GHG emissions (or anything else), and these, too, are automatically corrected by relative performance measurement. GHG emissions have decreased significantly during the COVID-19 pandemic. If you measure against absolute targets, you are doing well with no effort. But those who measure their GHG emissions relative to peers remain challenged and motivated even during the pronounced pandemic correction. The yardstick remains both fair and demanding in upturns and downturns.

Finally, mistrust and conflicts of interest are eliminated in this method while intrinsic motivation remains intact, unleashing companywide teamwork in the pursuit of genuinely shared values. These values are translated into truly aspirational goals without artificially set limits. These benefits far outweigh the two relatively minor costs of this method: potential debate over some peers or metrics, as mentioned earlier, and the need to monitor and collect data on peers. Indeed, the real disadvantage of relative performance measurement is not a technical or procedural obstacle but a political one. Management must relinquish absolute control over their company's and their own "performance story."

The use of independent ESG rating agencies is a third option for performance measurement in ESG bonus plans, and the main advantage to recommend them is credibility. This credibility comes first in the form of their technical ability. These agencies are major data and financial research providers that also rate the bonds of listed companies and are widely used by major institutional investors such as pension funds.

ESG rating agencies are also independent, conferring a second form of credibility to them. Their services are paid for primarily by investors, whose interests only partially coincide with those of company management because those interests also include the public and other stakeholders. Thus, ESG rating agencies enjoy broad recognition and are widely accepted, both for their expertise and their independence. Finally, the actual ESG performance measurements of rating agencies are also largely independent of the organizations being measured. The problems of internal target negotiations do not exist in their form of ESG performance measurement.

However, the very independence of these rating agencies also creates their first drawback: a lack of transparency. Ratings agencies focus largely on undiscovered information because everything that is already known in the market is assumed to be reflected in the share prices. But the question of where interesting investment opportunities may arise based on hidden ESG strengths and weaknesses, or opportunities and threats, is fundamentally different from the question of good ESG performance.

The rating agencies do not separate these two questions, which dilutes the relevance of their ratings for use in compensation. And because ESG ratings are supposed to contain relevant information for investment decisions, the rating process itself is sometimes also an industry trade secret. For all of these reasons, the lack of transparency in rating agencies is a major limitation to using them for measuring ESG performance in executive incentive compensation schemes.

Another serious problem with ESG ratings is that they are based on value judgments. Indeed, that is their central focus. However, value judgments are a very individual matter and rating agencies neither make their own value judgments transparent nor can they possibly know what those are for each individual: "Should we invest in defense and armaments?" "Support alcohol, tobacco and prescription painkillers?" "Co-finance family-planning drugs?" "What about oil, coal and nuclear power?" The rating agencies usually assume we're all on the same page here, but these questions can be approached in a variety of ways. No company can outsource this essential value dialogue and decision-making process to a third party, especially one that does not openly represent its own principles.

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A final disadvantage to using ESG ratings is that they are largely static, both over time and in terms of the measurement approach. When an ESG condition is measured, it is not possible to assess how the current period has contributed to that condition because performance is a dynamic consideration. Power is created when you change from one position to another. Of course, ratings also change, but slowly. Refinitiv, for example, one of the largest ratings agencies, delineates nine different levels, from D- to A+. Companies climb these levels very slowly. Once the low-hanging "ESG fruits" have been harvested, a change in the rating is only possible over several years. This is a problem for variable compensation plans, because without variability in the performance indicator, there is no variability in compensation. Therefore, the use of ESG ratings in executive bonus plans is limited.

ESG PERFORMANCE EVALUATION

With the fourth and final method, ESG performance evaluation, a reasoned assessment or judgment, is made about ESG performance after the performance period (ex post). This evaluation may be prepared or made by higher authorities, such as a supervisory body or independent third parties, and justifies the level of remuneration for the performance components.

The first advantage of ex post performance evaluations is that they are highly motivating as behavioral experiments have repeatedly shown (Chi, Liu, Qian, and Ye 2019). After all, obtaining a good judgment is a challenge that never ends. This fact suggests the second advantage of after-the-fact evaluations: They are inherently relative. So just like relative performance goals, they remain flexible and challenging under all conditions (especially when actually using relative performance measurement, agency ratings, or both). If the economy is doing well, the judges know this and expect more. If fewer greenhouse gases are emitted in a pandemic, that is not yet a success. One can only be judged successful when emissions have been reduced more than other market participants.

Lastly, ex post performance evaluations may also use any and all of the first three methods of ESG performance measurement in combination (ex ante negotiated targets, relative ESG performance and the findings of ESG ratings agencies). The hope is to combine the advantages of the other three methods, while their disadvantages will not be additive but rather will compensate for one another. Further, ex post performance evaluations are not limited to the hard facts of the other three methods. Instead, they put the facts into a broader context, so that one may finally arrive at a well-founded assessment of a company's (or unit's) ESG performance.

Of course, these assessments and their authors must enjoy a high level of trust and acceptance to make such judgments at their discretion. This is the first disadvantage of ex post performance evaluations. These kinds of assessments require competent authors who present their findings credibly and transparently. At the top management level, the supervisory bodies may have the authority and respect required for such tasks, and also the necessary competencies and resources. The making of these evaluation judgments does also require a certain amount of effort — the second drawback associated with them. But in the end, these are both aspects required of good corporate governance even without remuneration plans. Probably the most serious disadvantage of performance appraisals is that they have become out of fashion. In my experience, many supervisory bodies shy away from them because they give the impression of non-transparency and too much discretion. Shareholder representatives tend to be skeptical about performance appraisals.

POLITICAL CONSIDERATIONS

Which of these methods is most likely to be used in practice? Management consultants know from experience that it is not always the most sensible solution that prevails but ultimately the one that gives the majority an advantage. That is why ESG targets are most commonly used in executive incentive compensation plans: They are controlled internally. Relative ESG performance and ESG ratings, by contrast, are both external benchmarks that appear to be beyond the control of management. It is likely the reason these two approaches are hardly ever used in practice. However, this apparent lack of control by management dissolves under closer inspection.

In the case of relative ESG performance, it can be argued that its primary purpose and effect is, in fact, the exact opposite of limiting management's control. Relative performance measurement neutralizes external factors — such as technical changes and the general state of the economy — which by definition are outside of management's control. Thus, relative performance measures only what managers can control. Seen in this light, relative performance measurement allows more control than internally negotiated targets, not less. Internal targets only include what is expected at the time they are set. If the economy collapses or new technologies make it difficult to achieve those targets, there is little managers can do. Not so with relative ESG performance measurement.

Unfortunately, in my experience, the majority of decision makers are not amenable to this line of reasoning. Perhaps it is because elaborate goal-setting processes give a false sense of security. As a result, negotiated targets are generally more trusted than comparison to peer companies.

The same logic can be applied to measurement by ESG ratings agencies: they, too, are externally controlled and so appear at first glance to disempower managers. But ratings are also inherently relative. Ratings agencies cannot measure success compared to internally set targets they do not know. They inevitably compare a rated company's performance to what similar companies have achieved under similar conditions, which is all they can or do know.

But once again, bonus plans show a surprising lack of ESG ratings to measure ESG performance. This is especially true considering that all the major rating agencies already factor in the degree to which companies use ESG incentives in executive compensation. Perhaps the ratings agencies should take note. Rating agencies could find two advantages to tracking whether and how much their rated companies' bonus plans use the more accurate and challenging measurement methods of relative performance and their own agency's ratings. They might find it increases not only the general utility and acceptance of their ratings, but also their actual use as a performance metric in their rated companies' bonus plans.

Finally, perhaps after-the-fact ESG performance evaluations can help overcome resistance to ESG relative performance measurement and ratings. That is because like the first and favored method, internally negotiated targets, ex post evaluations are internally controlled. In fact, after-the-fact evaluations combine the benefits of both types of assessment -- they are internally controlled and also inherently relative. By their very nature, they take into account the overall context in which the performance has occurred.

Moreover, ex post performance evaluations can themselves be the context in which relative and ratings performance take place. And this also makes use of them when they are more likely to be trusted: after the fact. In my experience, relative performance measurement hardly ever triggers resistance or lack of understanding in retrospect. This may be because people tend to think relatively already. In all of life, we measure ourselves compared to others, on the leaderboard, against a benchmark, beside our neighbors. "Was it a good year?" can ultimately only be answered by comparing it with the others. A high benchmark statistic is not good if the similar measurements of comparable companies are even higher, and vice versa.

For all of these reasons, and because after-the-fact evaluations combine and enhance the advantages of the other three methods without their most glaring disadvantages, I recommend using this method as the integrating framework combining all four methods of performance measurement in ESG incentive compensation systems. It is true, such a framework will require comprehensive documentation and processes in place to subject judgments made to substantial and effective critical review. Such mechanisms are only just beginning to exist among shareholder representatives, much less to gain full social legitimacy. But to create, strengthen and institutionalize them is worth the effort if we truly want better bonus plans to incentivize genuine ESG outperformance.

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