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Global Headquarters
14040 N. Northsight Blvd.
Scottsdale, AZ 85260 USA

Canada
P.O. Box 4520
Postal Station A
Toronto, ON M5W 4M4

Contact Us
877-951-9191 (U.S. & Canada)
+1 480-951-9191 (other countries)
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Research Shows ESG Metrics Increasing in European Executive Compensation

Jim Fickess
WorldatWork

According to innovative research, the use of ESG metrics in executive compensation is increasing in Europe.

Obermatt, a Zurich, Switzerland-based leader in business-performance measurement, took a multi-pronged approach to that research (Stern 2022a). First, the company conducted two rounds of discussion on the aspects of ESG — environmental, social and governance — gathering insights from sustainability, compensation, HR and investor-relations professionals from 87 companies, primarily in Germany and Switzerland. It also conducted online surveys to gain quantitative knowledge of the market. Finally, it collected anecdotal input from the discussion rounds as well as one-on-one conversations with Obermatt CEO Hermann J. Stern, Ph.D.

The growing importance of ESG in executive compensation has been well documented (Christie 2021; Fickess 2021; Hildyard and Kay 2021). Likewise, the challenges of quantifying ESG in an executive compensation plan have been extensively discussed (Workiva 2022; Damsker 2022; Delves 2021; Becker and Groeninger 2021).

Obermatt's research provides HR practitioners with real-time information that can lead to future success, Stern (2022b) said. "ESG rating services often use different metrics than companies as their mission and goals differ from the issuers themselves." The Obermatt method measures true performance relative to peers filtering out macroeconomic impacts (such as the pandemic and inflation) coming into play. It's a better approach than comparing yourself to your long-term objectives, "which can be influenced by outside factors beyond their control."

The push for ESG compensation metrics is both external and internal, he added. "I am really surprised by the motivation coming from within the companies, not just the shareholders. Many management teams are concerned."

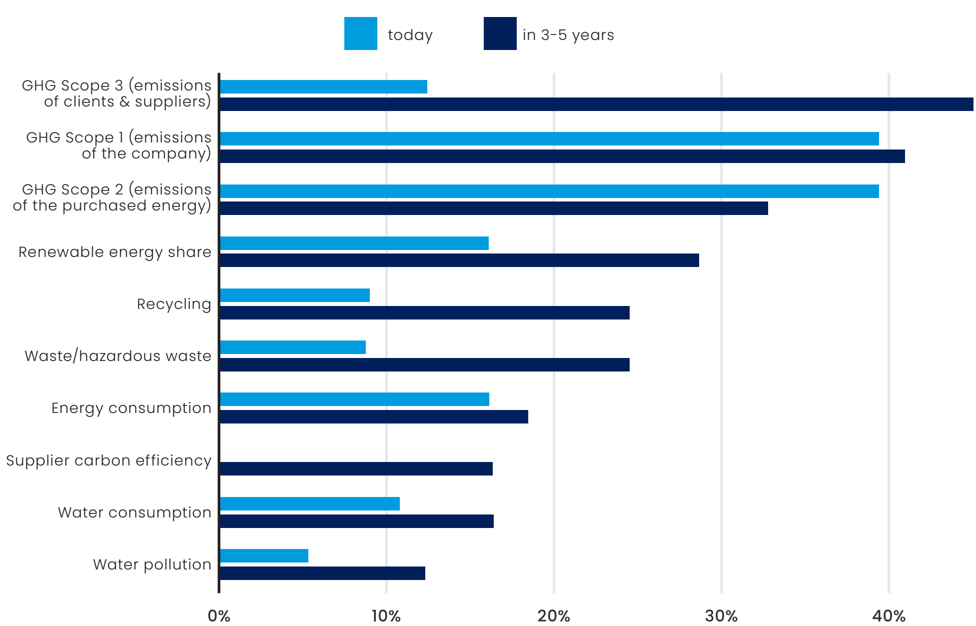
Next are the highlights of ESG research divided by category, with current and future use of environmental, social and governance metrics. The findings reflect survey results, discussions among experts and one-on-one interviews with Stern.

ENVIRONMENTAL METRICS

Survey

The survey was conducted during online sessions March 30 and April 5, 2022, with 62 ESG experts, mostly from Germany, Switzerland and the rest of Europe, including the United Kingdom (UK).

FIGURE 1 Environmental Metrics in Executive Compensation Systems



- The greatest increase in future metrics is expected to be for greenhouse gas emissions (GHG) of clients and suppliers, quadrupling from 13% to 45% in the next three to five years. GHG is a highly strategic metric for any company.
- Surprisingly, the use of metrics for GHG emissions from the company and from energy sources for the company will recede. This may be due to expectations that those targets will be achieved within five years.
- In all other categories, the use of environmental metrics is expected to increase.
- Energy consumption may have a higher relevance than recognized today if energy price volatility increases, as seems possible now because of recent natural disasters and geopolitical instabilities.

MISSING METRICS

Participants were asked what metrics they used that were not on the list. They were:

- Life cycle analysis for all products
- Clean tech
- Circularity
- Share of "green" revenues
- Ecodesign
- Biodiversity impact

EXPERIENCE SHARING FROM DISCUSSIONS

- An industrial conglomerate uses its science-based targets initiative (SBTI) pledge as goals to set expectations for compensation purposes.
- A construction supplier created a sustainability index (a consolidated ESG achievement metric similar to an ESG rating). It turned out to be too complex and too cumbersome to consolidate and was subsequently abandoned. The company now measures the GHG emissions of its construction products at the customer side, including length of the life cycle.
- A large chemical company used the share of sustainable products in its compensation offerings. The target was achieved quickly and eliminated from the ESG compensation system.
- A large construction industry building components and tools supplier experienced high volatility in its GHG emissions due to the pandemic and now inflation.
- A building supplier believes in soft targets and focuses on culture instead of hard ESG targets. It created a movement for sustainability that is based on voluntary contributions. This led to a new code of conduct. ESG has not been introduced in compensation for that purpose. The company relies on self-motivation. It uses GHG penalties in new investment proposals (GHG-related financial charges in the financial plan).
- A construction supplier intends to build an index from environmental and social elements with a focus to reduce GHG emissions year-to-year with a fixed target.

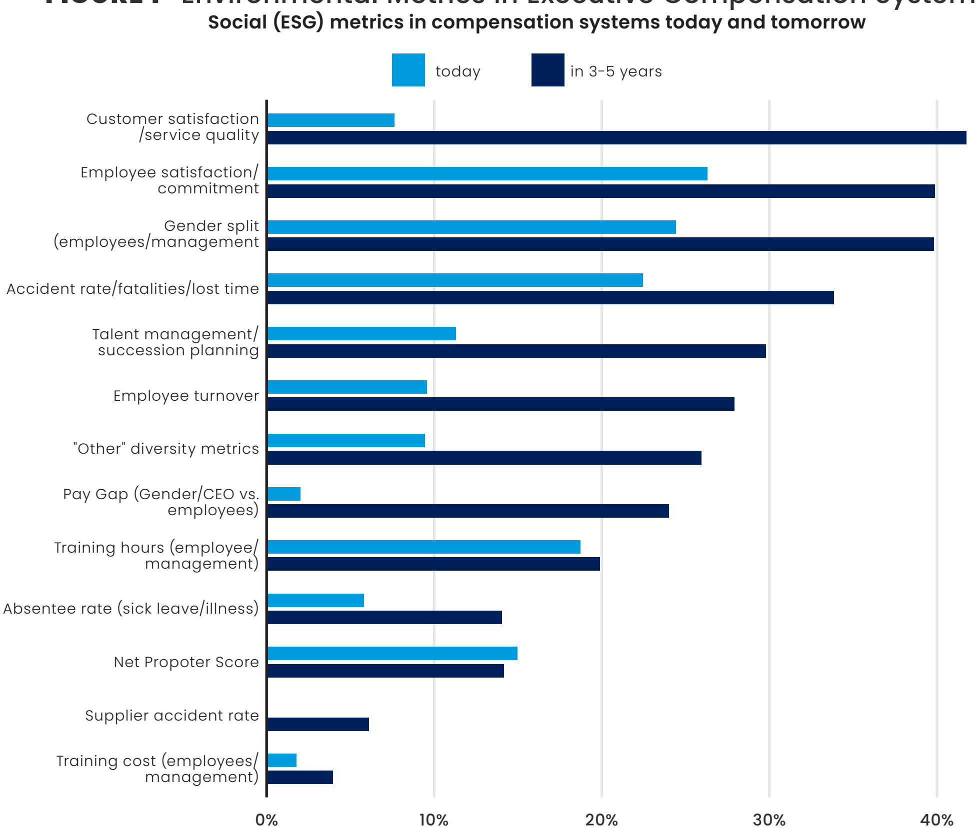
- A diversified industrial conglomerate has moved from a qualitative assessment to a quantitative assessment, which includes science-based target initiatives (SBTI) GHG targets, energy efficiency targets for capital expenditures and gender targets. It also uses supply-chain targets.
- A traditional Swiss machine manufacturer uses the levels of capital expenditure and revenue that go into clean-tech products.
- A Swiss insurance company uses ESG metrics as qualitative input to the funding of variable compensation.
- A large German construction component supplier applies the share of recycled materials used.
- A Swiss electrical components supplier uses the company's energy efficiency and raw materials used.
- A large Swiss construction supplier uses carbon dioxide emissions on an absolute reduction basis as well as increases in water-use efficiency.

SOCIAL METRICS

Survey

Like the environmental survey, this one was conducted during was conducted during March 30 and April 5, 2022, online sessions with 62 ESG experts, largely from Switzerland, Germany with some from the rest of Europe, including the UK.

FIGURE 1 Environmental Metrics in Executive Compensation Systems



- The most striking increase in the use of social metrics in the coming three to five years are in the areas of customer satisfaction (8% to 42%) and employee satisfaction (26% to 40%).
- Diversity metrics are also expected to see a significant increase, as seen in metrics such as gender split (25% to 40%), pay gap (2% to 24%) and "other" (9% to 26%) diversity metrics.
- Surprisingly, the use of training hours and net promoter score (the likelihood to recommend a company) is expected to stay at the current level.
- In all other categories, the use of social metrics is expected to increase, in some cases quite significantly.

MISSING METRICS

Participants were asked what metrics they used that were not on the list. They were:

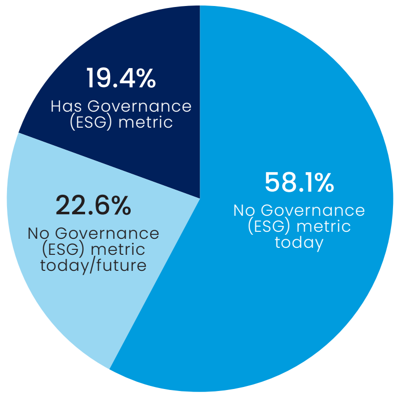
- People with disabilities
- Employee health/well-being
- Globality
- Female talent turnover
- Gender equity

EXPERIENCE SHARING FROM DISCUSSION

- An employee survey used as the basis of an ESG metric may provide the paradoxical situation where employees fill out questionnaires with the aim to maximize their compensation.
- Learning hours may be highly volatile and lose relevance in situations, such as the pandemic, when in-person training was not possible.
- Learning hours are difficult to measure if digital learning is relevant. How is online training accounted for through web universities and YouTube?
- The share of employees passing a compliance test is compensation-relevant at a company that saw success rates on compliance tests skyrocket.
- An industrial company had difficulties maintaining its net promoter score during the pandemic due to supply constraints outside the scope of influence of management (and not standardized or indexed to neutralize the external effects from the global supply chain disruptions).
- It is difficult to maintain employee satisfaction during times of downsizing.
- One industrial conglomerate uses climate, inclusion, safety (accidents, data safety), employee development and innovation in its ESG compensation.
- A traditional Swiss machine manufacturer uses diversity actions instead of a diversity metric. In other words, it evaluates policies, programs and initiatives (projects). Another company did the same and made an increase in the share of women in management a part of its objectives rather than tying it to compensation.

- An entertainment company uses the gender pay gap, gender equity and giving the underprivileged access to higher paying jobs as metrics. Measuring diversity, equity and inclusion (DEI) is based on a metric for sexual orientation, women of color and gender acceleration.
- A bank has employee turnover and management development targets. Recently, the pay gap became a key figure for its investors. The bank found that in the social category, different rating agencies have different demands: Institutional Shareholder Services (ISS) strictly demands a 30% share of women on the board of directors while Glass Lewis & Co. LLC and Ethos Services SA are more lenient.
- A leading technology company reports that at its annual shareholder meeting, the main topic from investors was ESG targets, not financial or strategic goals. Its three long-term incentive (LTI) targets (net promoter score, digital training hours and carbon emissions) were received. But shareholders said the company should disclose ex ante targets and increase the importance of ESG by increasing the share in LTI from 20% to 25% or even 30%.
- A Swiss leader in elastomer components has 20% of its bonus linked to ESG targets in its short-term incentives (STI) (accident severity and employee commitment). The company questions the fairness of the employee survey. In addition, it has a sustainability road map with ESG targets that are not linked to remuneration.
- A manufacturing company links gender ratio to CEO and business unit presidents' compensation. This is also broken down to staff managers without a tie to compensation.
- A large German travel and logistics company uses net promoter score and an employee engagement index in its STI. It has opted against a customer satisfaction survey index and diversity and health targets.

FIGURE 3 Organizations Using Governance Metrics in Executive Compensation



GOVERNANCE

Survey

The survey was conducted during June 15 and 23, 2022, online sessions with 69 ESG experts, mostly from Germany, Switzerland and the rest of Europe, including the UK.

- Only 19% of the experts use government metrics in their compensation systems, much fewer than social and environment metrics.

- Of the 80% that have no governance metrics in the compensation plans, 23% never expect to introduce such metrics.

The interviews showed the finance industry is the most keen on using governance ESG metrics. Typical metrics are compliance, risk management and conduct.

MISSING METRICS

Participants were asked what metrics they used that were not on the list. They were:

- Data security and privacy
- Cybersecurity maturity level based on an independent assessment.

EXPERIENCE SHARING

Not surprisingly, there was little experience sharing on the governance metrics as many experts have expressed reservations about governance metrics in compensation, with the exception of financial service providers and companies in sustainably sensitive industries such as gambling and tobacco. Stern (2022b) said governance metrics are "more about checking the box on compliance and ethical issues. Environment and social metrics are more measurable."

- A Swiss financial service provider expresses the experience that governance, especially safety and compliance metrics, has already been relevant for investors. Reputation is important in this sector, so this has been a compensation-relevant metric for a long time.
- A Swiss regional bank explains that a risk-adjusted profit already contains "safety metrics" (capital at risk) and is therefore already included in the financial component. Other ESG metrics can be as relevant as to cancel all variable compensation under certain conditions.
- Participants offered a few ways to measure governance metrics, including compliance training hours employees (industrial conglomerate); compliance tests completed (global logistics company, machine manufacturer); and share of suppliers signed up to code of conduct (machine manufacturer).
- An expert mentioned the opinion that governance is a given that doesn't have a performance characteristic. This opinion was widely shared in the round. The ESG experts think governance is cultural and the basis of doing business, not something to optimize.

Obermatt, which focuses on ESG and compensation, also asked the research participants about the number and mix of ESG metrics they use in their compensation plans. Those results will be shared in a future *Journal of Total Rewards* paper.

"ESG is crucial but nonfinancial and difficult to measure," Stern (2022b) said. "Jeff Bezos never looked at profits in Amazon's early days but looked at growth indicators.

"People who are in the ESG space today will have future success."

ABOUT THE AUTHOR

Jim Fickess (jim.fickess@worldatwork) is an editor and writer for WorldatWork, focusing on *The Journal of Total Rewards*. He has worked more than 40 years in publications, mostly as a newspaper and news website journalist. Fickess has a BA in social science education from the University of Northern Iowa and a master's in mass communication from Arizona State University's Walter Cronkite School of Journalism and Mass Communication, where he was a longtime adjunct professor.

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