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ESG METRICS EXPANDING IN EXECUTIVE COMPENSATION

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The use of environmental, social and governance (ESG) metrics is accelerating its metamorphosis from a feel-good frill to an integral part of executive compensation, research confirms.

A multi-pronged study by Zurich, Switzerland-based Obermatt found all participating European companies plan to include ESG requirements in their executive compensation plans within the next five years. (Stern 2022a).

ESG metrics also are increasingly appearing in executive compensation plans in large U.S. companies, with 73% using at least one metric in 2021, up from 66% in 2020 (Conference Board 2022).

Further, adoption in the United States is likely to increase in the wake of a November 2022 Department of Labor ruling that allows fiduciaries to consider climate change and other ESG factors when selecting retirement investments and exercising shareholder rights (Starner 2022). Certainly, shareholders and compensation committees will want to incent top executives to pursue ESG actions that draw investments into — and raise stock prices of — the company.

In Canada, 80% of public companies use at least one ESG metric in their executive compensation plans, with social factors (78%) being the most prevalent measure (Benefits Canada 2022).

"I haven't met a single person in the last year who doesn't consider ESG to be an important aspect of executive compensation," said Hermann J. Stern, Ph.D., CEO of Obermatt, which conducts business-performance measures and has done extensive research in the use of ESG metrics in compensation (Stern 2022b). Stern added that roughly 20% of the people he has spoken with don't currently use ESG metrics in executive compensation but expect to do so in three to five years.

People tend to think of ESG as being altruistic, Stern said, but that misses the potential strategic impact these measures can provide to a business.

"ESG is future-focused. It's about risk management and development — of products and people, " Stern said. "Investors pay attention (to ESG) because it makes for better investments. By not having ESG metrics, you are essentially saying you don't care about the company's future."

At the same time, many companies focus on metrics that are backward-looking and short-sighted by design — such as quarterly profit and loss measures, Stern contended.

An earlier *Journal of Total Rewards* paper on the Obermatt research project described the increased use of ESG metrics in European executive compensation plans (Fickess 2022).

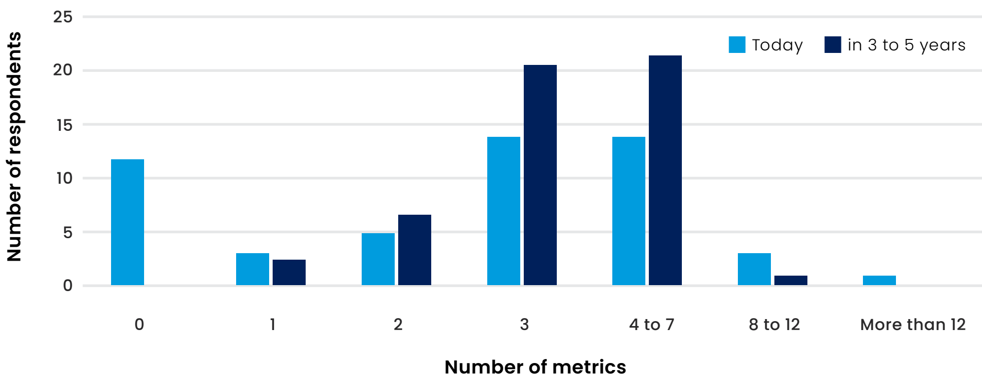
This article will focus on the number and kind of ESG metrics that companies are using, or plan to use, in their executive compensation programs, as well as how these metrics are incorporated into long- and short-term incentives (LTIs and STIs.)

COMPENSATION DESIGN

Recognizing the hidden complexity in what seems a straight-forward integration of ESG metrics, Obermatt continued its research. The Obermatt research began by gathering insights from sustainability, compensation, HR and investor-relations professionals from 87 companies, primarily in Germany and Switzerland. It also employed online surveys to gain quantitative knowledge of the market. The surveys were conducted during online sessions held March 30 and April 5, 2022, with about 60 ESG experts, mostly from Germany, Switzerland and the rest of Europe, including the United Kingdom.

Finally, the research garnered anecdotal input from participant discussions as well as one-on-one conversations with Stern.

FIGURE 1 How Many ESG Metrics Should Be Compensation-Relevant?



Based on responses in two workshops, all experts expect to include ESG in their executive compensation systems within three to five years. While some companies use one or two metrics, most ESG experts use three to seven metrics; 80% of the participating companies expect to use three to seven metrics in the next three to five years.

EXPERIENCE SHARING: HOW MANY METRICS?

The number of metrics being used varies widely across companies. Some believe that focusing on fewer metrics is more manageable and leads to better results. Others feel that a larger number of metrics works better for their organizations. Here are some of the perspectives from various companies regarding the number of ESG metrics they employ:

- A Swiss machine manufacturer insists on using just one environmental metric because it thinks having too many metrics dilutes the incentive.
- Similarly, a German chemical company uses just one ESG metric in its LTIs (at 40%) and one in its STIs (at 20%), because it believes that using fewer metrics means more focus on those metrics and that having more metrics may dilute the incentive.
- A logistics company has one to three targets, focusing on low-hanging fruit to create a "wow effect" and foster sustainability discussions among employees.
- An energy company has three metrics in its LTIs (one in each of the ESG elements and each at a 7% share of the LTI budget). It has also added sustainability targets in its individual goals.
- A construction component supplier started with 11 targets and will reduce this to seven because target-setting at the board level was too demanding. In addition, it feared that too many targets could become irrelevant.

- A diversified industrial conglomerate uses 20 to 30 targets across 10 categories. They are mostly individual targets based on the ESG sensitivity of the area of responsibility.
- A leading German automotive supplier believes that using only a few metrics is cherry-picking, and that sustainability is a large area that cannot be captured in just two to three metrics.

SHARE OF ESG COMPONENT IN VARIABLE COMPENSATION

Many companies include ESG as a component in their variable compensation. But deciding which form ESG should take can spark lively compensation discussions, including ones as part of the Obermatt research. The majority opinion of the expert exchange is that ESG should be included in both LTI and STI, Stern (2022b) reported.

Stern supports the use of ESG metrics in both LTIs and STIs. His reasoning: While ESG is long-term, annual STI payouts are more relevant.

"It is intuitive to put something long range, such as ESG, into long-term incentives," Stern (2022b) said. "But people don't look at long-term incentives immediately. If you link pay to 10% or 20% of their short-term compensation for the year, their actions will be more immediate. This is why we recommend our clients use important non-financial performance metrics in STI plans."

Some metrics, such as accident rates, customer satisfaction surveys and diversity targets, are stable over time and are better suited for LTIs, Stern explained. Targets that require a large, concentrated effort — such as reductions in emissions and better energy and water efficiency — need annual target-setting and are therefore better suited for STIs.

The share of the ESG performance component is expected to increase in both STI and LTI plans and continue to be more significant in LTIs, according to surveys Stern conducted June 15 and 23 during online sessions. (See Figures 2 and 3.)

FIGURE 2 STI Today and Expected in 3-5 Years

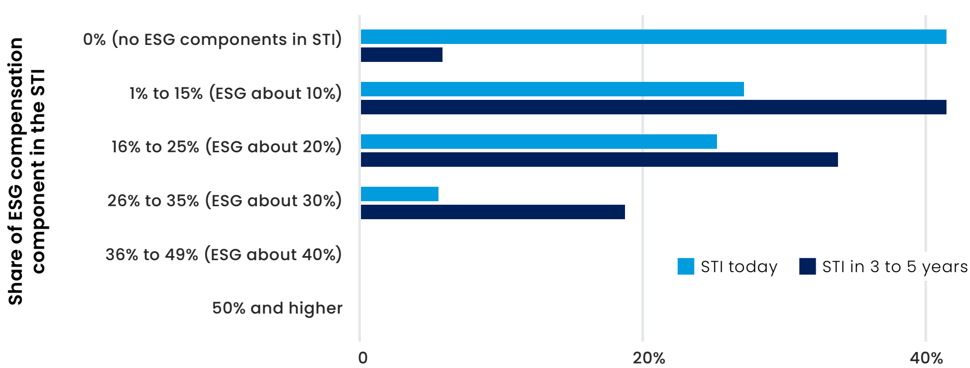
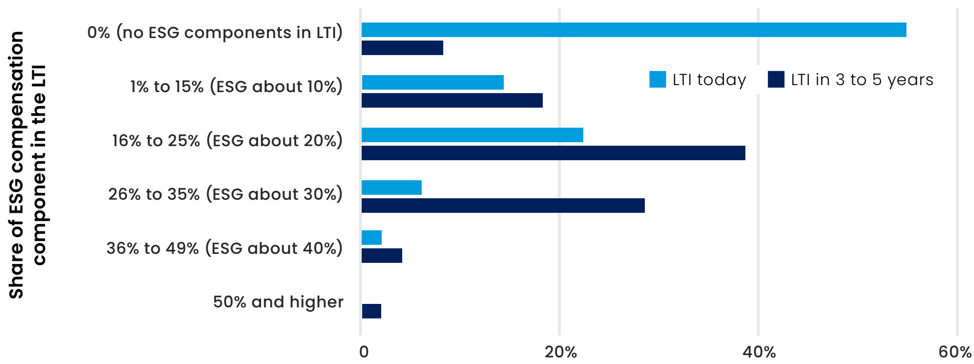


FIGURE 3 LTI Now and Expected in 3-5 Years



Figures 4 and 5 show individual answers represented by blue dots.

In Figure 4, ESG is displayed as the percentage of total compensation (average of STI and LTI). On the horizontal axis, one sees how high the ESG component is today, while on the vertical axis, one sees where it is expected to be in the next three to five years.

FIGURE 4 ESG Share of Total Compensation (Fixed and Variable) Today and Expected in 3-5 Years

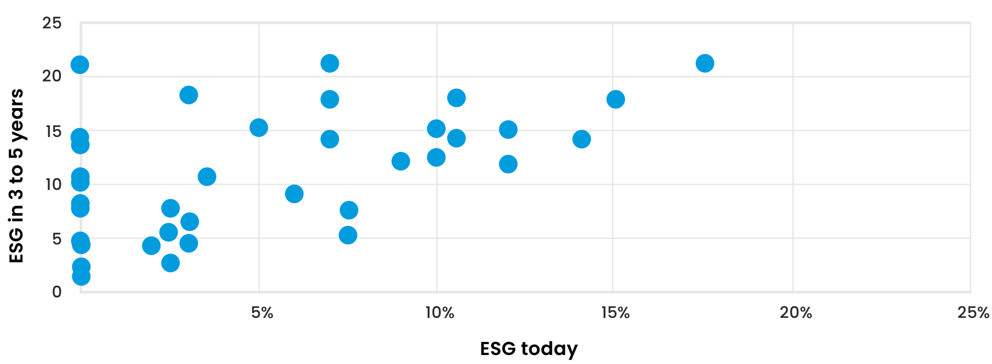


FIGURE 5 ESG Share of Variable Compensation Today and Expected in 3-5 Years

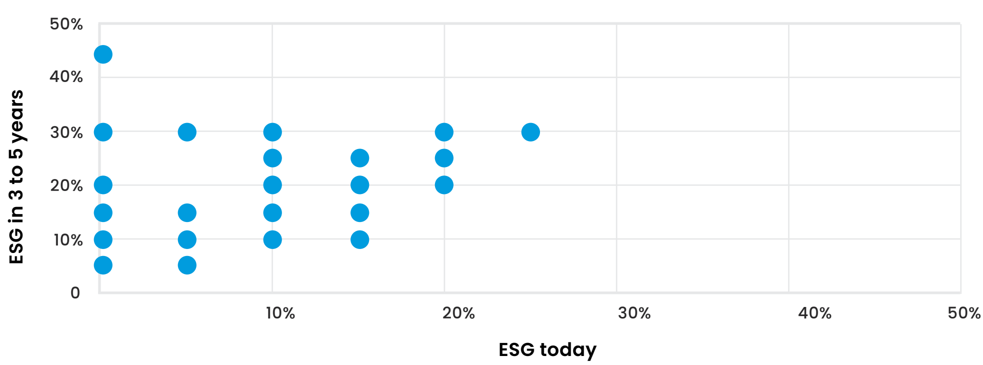


Figure 5 shows how many companies expect to increase the use of ESG metrics in variable compensation in three to five years. There is only one dot below the diagonal line which means only one expert intends to reduce the ESG component (from 15% to 10%). All other participants expect increases.

EXPERIENCE SHARING: USING ESG METRICS IN BOTH LTIS AND STIS

Some organizations use certain criteria to determine if ESG metrics should appear in LTIs or STIs. Several participants use ESG metrics in both forms of incentive.

- One participant suggested using the method of measuring performance to decide if an ESG metric would be used for STIs or LTIs. Metrics that can be measured against peers — as is the case with most environmental metrics and some employee and customer metrics — are better suited for LTI programs, this participant opined. If metrics require a one-time effort, are personal objectives or can be measured only against internal targets, they are better suited for STI programs.
- A traditional Swiss machine manufacturer uses ESG in both STI (for individual objectives, environment and social metrics) and LTI (for CO2 emissions, accident safety, diversity actions).
- A large Swiss construction supplier thinks that long-term targets should go to the LTI, short-term targets to the STI. However, the company acknowledges that emission targets are long-term and difficult to set three years in advance. Health and safety metrics fall in STIs.
- A global German material handling and warehousing supplier uses the same ESG metrics in both STIs and LTIs for the first three management levels, with higher targets in the LTIs. The LTI target is the end point after three years. The STI target moves into the direction of the LTI target over time.
- A Swiss chemical company added ESG metrics to its LTIs in 2021. Because of the nature of the ESG metrics (e.g., diversity), it found them less applicable to a broad group of employees. It uses ESG metrics in LTIs for 500 employees, while STIs cover about 6,000.
- A large German industrial conglomerate has ESG in both STIs and LTIs. In STIs, which are used for the company's 7,000 employees, it uses individual and mostly qualitative targets. In LTIs, which apply only at the executive or board level, it uses quantitative targets. Setting these targets over many years is challenging and often can lead to unexpected results that require adjustments.
- A German automotive supplier has ESG metrics in both STIs and LTIs. Climate neutrality appears in the LTIs while other, shorter-term goals — such as accident rate, diversity, and water consumption — appear in the STIs. These targets may change from year to year.

EXPERIENCE SHARING: REASONS FOR USING ESG METRICS IN STIS

- A German industrial conglomerate uses ESG metrics in the LTI program and is confident that it will include the metrics in the STI program in the near future. Its reasons: More employees are affected, focus can be retained because the goals are more immediate, and multiyear target-setting is often a challenge.
- A Swiss electrical components supplier and a Swiss financial institution use ESG only in the STI because of concerns about target-setting.
- At a Swiss industrial company, ESG is used in STIs as a mix of quantitative and qualitative evaluations, focused on business areas.
- A large German automotive supplier uses ESG in STIs only as a variable compensation component. So too does a fast-growing Swiss building supplier.
- A manufacturing company found the forecasting difficult in a volatile environment and decided to link its STIs to sales and the turnover of a specific site to create a ratio of sales of a site versus emissions. It is not sure if it is on the right track because it is omitting factors such as price increases and production mix.
- A Swiss industrial company uses ESG metrics in its STIs; ESG criteria are introduced with growing importance into the capital allocation process (new investment assessments).
- A Swiss industrial company uses ESG only in its STIs because it wants to go step by step and ensure visibility of progress. LTIs are less relevant and immediate for many employees. The company changes ESG criteria annually in an effort to involve as many employees as possible.
- A pharmaceutical company uses ESG in its STIs for all employees; investors are pushing for the use of ESG in LTIs, too.
- A Swiss industrial company uses ESG in the STI formula, which applies to 1,000 managers out of a total of 8,500 employees, because it reasons that ESG is a strategic priority that is carried by many employees. Using ESG in STIs helps ensure more relevance. Although the company's LTIs don't have ESG components, the STIs are based on milestones from a multiyear roadmap, which ensures a longer time horizon.
- A large German medical equipment manufacturer uses ESG metrics in STI plans on an individual basis.
- A global Swiss construction supplier uses ESG metrics only in its STIs because it uses these incentives broadly throughout the business. A company official thinks ESG metrics also should be used in LTIs but worries about resilience and avoiding misleading, undesired payout outcomes. That is a common concern and the reason that many of the experts in this study contended that sustainability is long-term and should be used in LTIs.

EXPERIENCE SHARING: REASONS FOR USING ESG METRICS IN LTIS

The following companies offered various reasons for using ESG metrics solely or primarily in LTIs.

- A large supplier of construction machinery, building components and tools thinks integrating ESG into STIs leads to short-termism, so it uses ESG metrics only in LTIs.
- A large German building equipment supplier rotates the ESG targets in its LTIs. Every new LTI has different ESG targets. In 2021, targets were health and safety. In 2022, the target was climate.
- A global German construction components supplier has ESG primarily in its LTI plan because these targets have long-term relevance.
- A large global German industrial conglomerate uses 20% ESG in its LTI formula with plans to increase that share. It sets and measures LTI targets annually and then aggregates them over a four-year LTI period. Expert roundtable participants found this to be a positive and intriguing idea. The conglomerate has eliminated individual targets for 7,000 of its 200,000 employees who have performance-based pay.
- An HR consulting company thinks that only environmental ESG metrics are useful in LTIs and that social metrics are less suited for LTIs.

EXPERIENCE SHARING: THE SHARE OF STIS AND LTIS IN THE ESG COMPONENT

There was general agreement among the experts to increase the share of compensation based on ESG for both STIs and LTIs. Below you can see snapshots of how much weight companies currently assign to ESG metrics for both forms of incentives.

- A large German chemical company sets its ESG components at 40% of executive compensation because it thinks ESG components (emissions and accident rates) are of high importance and should be rewarded now, rather than only later.
- A British compensation expert said that a 10% ESG share of executive compensation should be the maximum, because anything higher than that would jeopardize profit goals.
- A Swiss industrial company uses ESG metrics at 30% in its STIs.
- At a large Swiss construction supplier, ESG is 30% in LTIs and 15% in STIs.
- A Swiss industrial company has 20% ESG in the STI formula, which applies to 1,000 managers out of a total of 8,500 employees.
- A German industrial conglomerate has currently implemented ESG at 20% of the LTI program.
- A pharmaceutical company has 25% ESG in its STIs for all employees.
- At a Swiss industrial company, ESG is 10% of STIs.

EXPERIENCE SHARING: ESG METRICS FOR GROUP OR INDIVIDUAL PERFORMANCE

- A Swiss health insurance company intends to move from individual performance compensation to group performance compensation, saying individual performance evaluation results in a large workload with little benefits.
- A German retail bank has used ESG only in individual compensation until now. This year, it learned from investors that 20% ESG is expected in the group compensation.

RESEARCHING AND COMMUNICATING

Obermatt is continuing its research into 2023, focusing on such areas as inflation's effect on target-setting (Stern 2022b). For example, if carbon dioxide emissions are based on sales, sales totals can go up with inflation while production remains the same, making the emissions goals easier to attain, Stern explained. Measuring performance correctly is critical, so that compensation plans support a company's intentions, rather than delivering unpleasant surprises.

While ESG metrics are gaining popularity in compensation packages, especially for top executives, compensation and rewards professionals should not establish plans without first doing their homework. One way to do that is to monitor ESG data before using it as a metric tied to STIs or LTIs.

"Companies should consider using ESG operating goals for one to two years before including them in compensation," stated Merel Spierings, author of the Conference Board report on ESGs in U.S. executive compensation, in a press release. "That allows time to see if those goals are truly relevant for the business and to develop strong buy-in from management and employees. It is especially important for companies to both validate and broadly communicate ESG goals before rolling them out as part of compensation plans for a broader management or employee base."

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