Pearl Meyer

ADVISOR BLOG | OCT 2021

In the Headlong Rush to Put ESG Metrics into Incentive Plans, We May Need a Speed Bump



Mark Rosen

MANAGING DIRECTOR

Environmental, social, and governance-based incentive metrics are continuing their meteoric rise. Investors are asking about the link between ESG and executive compensation in shareholder outreach calls, meanwhile you can't attend a compensation committee meeting without talking about ESG. Institutional Shareholder Services' 2021 policy survey found that over 85% of investors think ESG should be incorporated into compensation plans. Our data from the 2021 proxy season shows 43% of the S&P 500 have an ESG metric in their incentive plans, and we predict the prevalence of ESG incentive metrics may increase materially next year as companies don't want to be left behind on this important trend. Swift action in response to shareholder and stakeholder input is to be commended. But it's possible we need a speed bump before rushing headlong into integrating ESG into incentive plans.

Given the high profile of ESG right now, there seems to be a default opinion emerging that ESG metrics should be in incentive plans. We can point to their high prevalence ("everyone else is doing it"), the importance of ESG to many investors ("let's make sure we are an attractive investment to ESG funds"), and the signaling effect inherent in incentive plan metrics ("what gets measured gets done"). All these positions are true. In fact, the signaling effect of incentive plan metrics is especially powerful. We communicate through incentive plans what is important to the organization—that's what we pay for, and it sends a very strong message to stakeholders.

However, before jumping on the runaway ESG incentive metric bandwagon, let's mind the speed bump and evaluate the benefits within our incentive plan principles:

- Are ESG metrics/goals integral to our business strategy?
- Should we incentivize ESG performance or is achievement a "table stake" that would/should be achieved anyway?
- Are the metrics sufficiently defined? Can we set robust goals and measure achievement, and can it be audited?
- Can we make a difference over the short term? Should the metric have a performance period longer than one year?

- Is the incentive material? Most ESG metrics are included in annual incentive plans. A typical plan may have 80% of the target incentive based on a financial metric(s), while 20% may be based on a group of non-financial metrics such as achieving strategic goals, safety, employee engagement, and customer satisfaction.
    - If ESG is added within what is only 20% to begin with, is it material enough?
    - If the weight on financial metrics is reduced/replaced with an ESG metric, are we sending the right message?
- Non-financial metrics tend to be evaluated holistically and frequently are achieved near target. Will adding an ESG metric align pay and performance or become an entitlement?
- Will shareholders accept paying for ESG performance when financial performance is poor or doesn't achieve threshold?

The bottom line question is whether putting ESG into incentive plans is really going to have an impact. There are many important goals that are not specified in the incentive plans. Most companies have already been considering progress on ESG goals, even if disclosure of ESG goals is just catching up. Ultimately, messaging the importance of ESG metrics may be the deciding factor. We expect many organizations will come to that conclusion. Just be sure to slow down and ensure these issues are considered before doing it because everyone else is.

About the Author

Mark is a consulting team leader who brings 20+ years advising on executive and board pay, including benchmarking, retirement plan design, and tax/accounting and governance considerations.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management helping organizations build, develop, and reward great leadership teams that drive long-term success. Our strategy-driven compensation and leadership consulting services act as powerful catalysts for value creation and competitive advantage by addressing the critical links between people and outcomes. Our clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private organizations to the Fortune 500.