



Incentivising ESG linked performance

Board Leadership Center (India)



Looking back at the decade that has been, the years gone by are a fitting reminder of the inevitable and unceasing nature of change. If the global pandemic and climate crisis has taught us anything at all, it is that the urgency of collaborative action is crucial to move the needle and achieve a sustainable tomorrow. The call for global action has now translated into active stakeholder dialogue to drive accountability across each organisation's long-term strategy, resulting in meaningful progress across critical issues such as climate change and the ESG crisis.

Previously, the ESG Council of KPMG in India's Board Leadership Center (BLC) has shared perspectives on operationalising ESG, navigating the business landscape post COP26, Board's role in shaping an organisation's ESG agenda, insights into Business Responsibility and Sustainability Report (BRSR) as well as ESG and the evolving role of employees. This edition deep dives into the importance of ESG consideration across incentivisation platforms in order to further organisation-wide performance across ESG ambitions, goals and targets.

The importance of ESG consideration across incentivisation platforms

The growing ESG momentum has translated into a focused topic of concern, particularly in the boardroom. Rising stakeholder sentiment is now pushing organisations to relay their commitment towards achieving their ESG ambitions. With increased expectations on an organisation's ESG progress, stakeholders are also demanding accountability from Boards. The connection between organisational purpose as well as ESG and employee engagement continues to strengthen its proposition in order to drive value generated outcomes for organisations across industries:

78%



Of organisations believe ESG is a **key contributor to strong financial performance**

Financial incentives have long been a practiced part of annual executive as well as long-term incentive performance plans. However, given the increased focus on ESG risks and material concerns, Boards are now more likely to hold executives accountable for result-oriented performance across ESG parameters. The question that comes into play is how effective is the integration of ESG performance measures into remuneration as well as reward and recognition platforms in order to drive result-oriented performance.

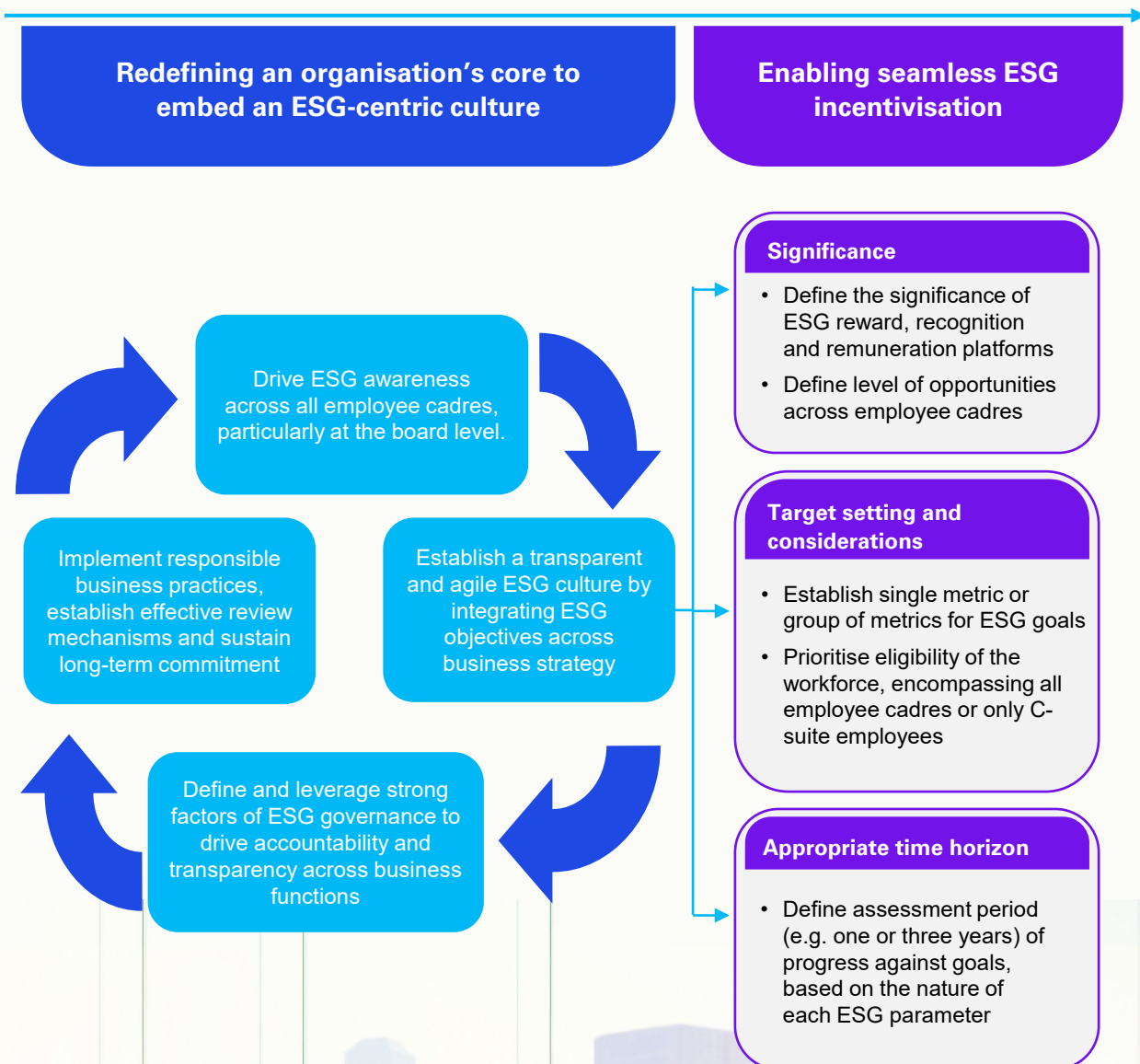
63%



Of organisations have already factored ESG into **annual/short-term incentives**

1. ESG survey of board members and senior executives, wtw, 2020

A robust ESG-centric culture enables organisations to effectively place elements of ESG in the context of incentivisation platforms



Moving beyond the C-suite

While most organisations might initiate the objective of ESG-linked incentivisation by restricting its application to the executive team and the C-suite, the question arises to the scope of responsibility for each ESG metric across the organisation. Goals such as the alignment of financial and strategic priorities on ESG might be more appropriately applicable to the CEO and executive team, while goals such as the integration of ESG initiatives in line with broader ESG goals and targets can be linked across employee cadres.

Case study

A global payments and technology company introduced a renewed compensation model in FY21 for the executive vice president level and above. ESG priorities of carbon neutrality, financial inclusion and gender pay parity are linked to their annual bonus structure. In order to enhance ESG accountability across the company, the compensation model was further extended to employees across the globe. Further, the company also ensured the outreach of its 'Corporate Score Rewards' to all its employees who achieved robust ESG performance results for the company. In FY22, the company took a bold step forward to state that ESG goals would now be linked to bonus calculations for all its employees, thereby vitalising accountability, performance success and recognition.



Designing an ESG-linked incentivisation framework^{2,3}

In the endeavour to establish a robust ESG-linked incentivisation framework, a balanced approach to ESG performance measures is a must. While organisations can use a mix of remuneration and reward platforms to incentivise ESG performance, the ESG metrics must have appropriate weightage and influence over business activities as well as the organisation's stakeholders. In this regard, there remains much to consider when prioritising which ESG metrics can be used to incentivise ESG performance across employee cadres. Organisations can conduct periodic stakeholder engagement and materiality assessments to incorporate multi-stakeholder feedback across priority ESG material issues for the organisation's business activities. In order to further communicate progress towards value-creation, interlinking progress across prioritised ESG metrics to the six capitals of value creation⁴ can encourage a long-term view when determining key ESG goals and targets.

Choosing the right ESG parameter is crucial for incentivising positive impact across the triple bottom line. Identifying targets and performance metrics will establish expectations for employees across cadres. However, it is crucial to remember to set realistic targets, as short-term targets should not impact long-term stakeholder value. Lofty

ambitions and overpromising transformation can bring negative impact across the organisation's ESG strategy, which can be challenging to explain and can further endanger the organisation's reputation with its stakeholders.

Further, companies who already have a strong ESG culture and strategy should be cautious when defining ESG incentives, so as to ensure a balance between ESG and corporate goals and targets.

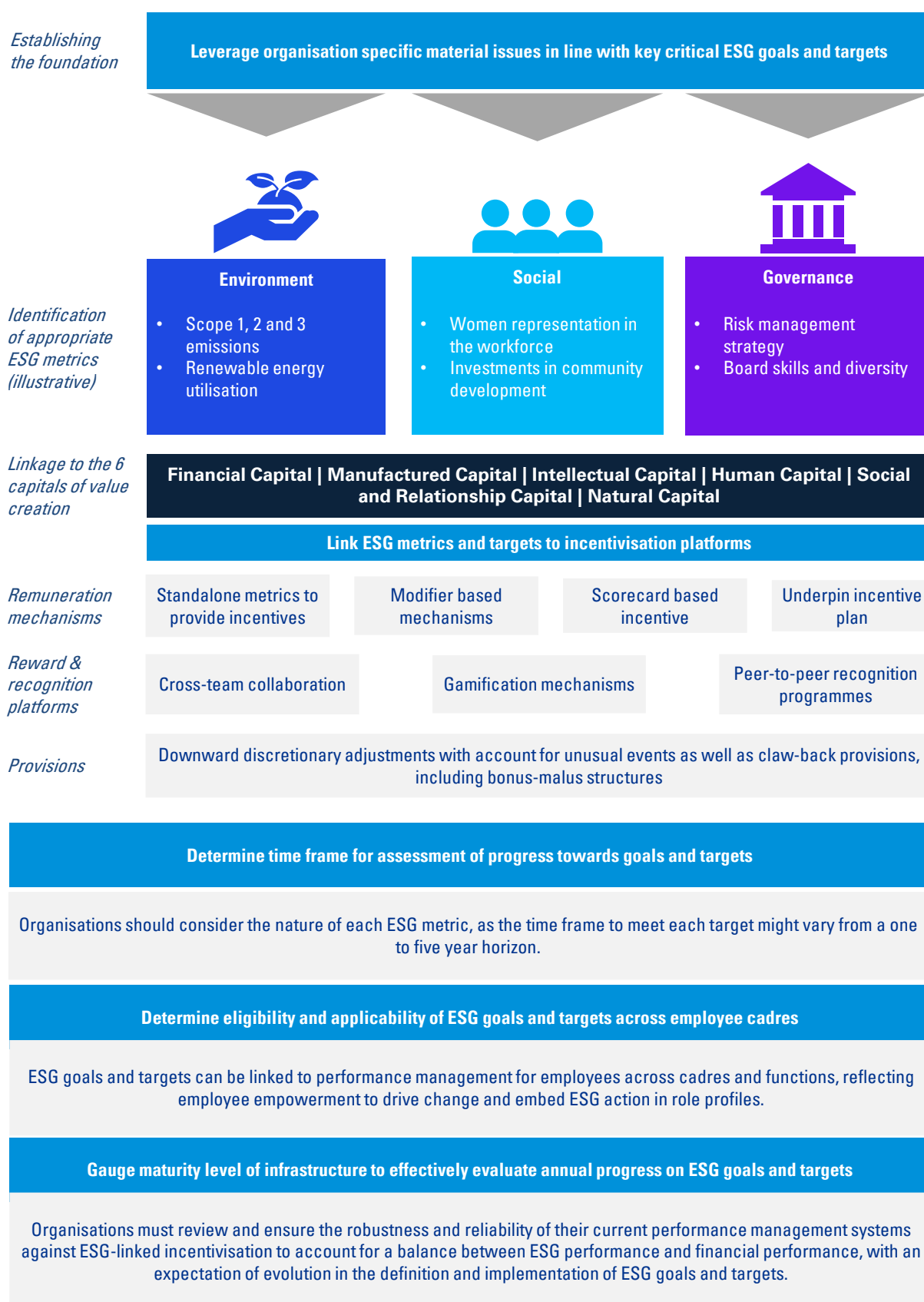
When considering new compensation measures, compensation committees must consider the risks of implementing incentivisation frameworks. Organisations should have a robust system where internal groups would be responsible for gathering relevant data, assessing performance, and ensuring effective board oversight. Furthermore, numerous ESG-related criteria are subjective in nature. This allows the compensation committee to have more discretion in evaluating performance. In this regard, developing a well-thought-out and structural strategy to reduce all risks and balance ESG performance against financial performance is essential. There are numerous remuneration and reward mechanisms that can be implemented in line with incentive payout opportunities.

Remuneration mechanisms	Standalone metrics to provide incentives	Modifier based mechanisms	Scorecard based incentive	Underpin incentive plan
	Includes pre-defined goals at threshold, target and maximum performance in line with payout opportunities.	Used to increase or decrease overall incentive payout, factoring in the rigor behind the ESG measures.	Includes four to five measures that are linked to defined weighting in the ESG-incentivisation plan	Includes measures that must be achieved before the incentive plan is implemented
Reward & recognition platforms	Cross-team collaboration	Gamification mechanisms	Peer-to-peer recognition programmes	
	Cross-functional collaboration to drive synergy across projects and effectively ensure holistic team progress	Digital platforms to boost user activity and drive progress across team engagements, ensuring actionable behaviour and accountability	Mechanisms to enable effective team building solutions whilst creating a recognition-rich culture that boosts employee morale and performance	

2. Incorporating ESG Measures Into Executive Compensation Plans, Harvard Law School Forum on Corporate Governance, 2021
3. The Perils and Questionable Promise of ESG-Based Compensation, Harvard Law School Forum on Corporate Governance, 2022

4. The capitals are categorised by the Value Reporting Foundation (VRF) into six categories of financial, manufactured, intellectual, human, social and relationship and natural capital.

The framework below aims to accelerate the effective integration of ESG metrics across incentivisation platforms with guidance on provisions as well as timely assessment of progress against goals and targets, augmenting the success rate of ESG incentivisation.

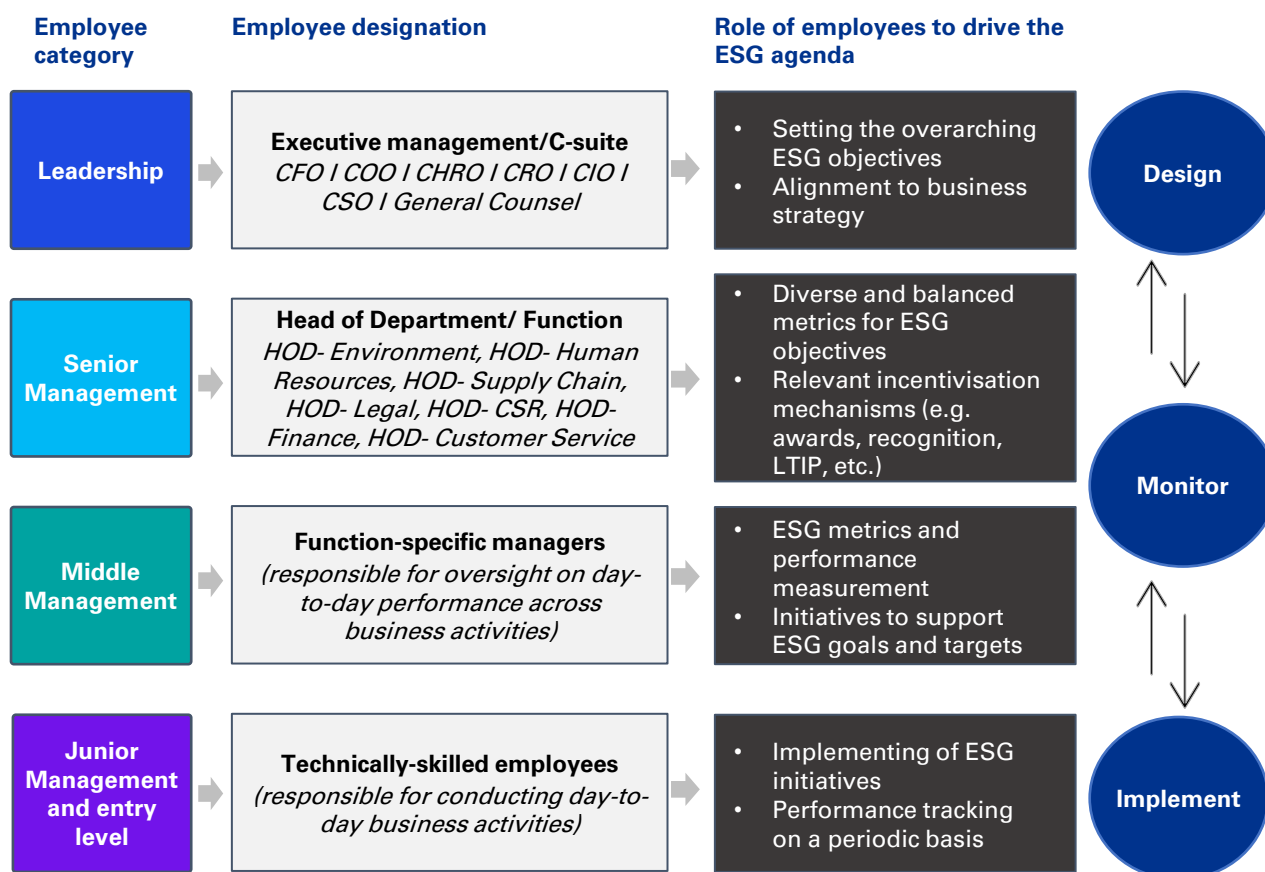


Implementation of an ESG-linked incentivisation framework^{5,6}

Integrating ESG across the short, medium and long-term business strategy of an organisation is crucial to drive consistent and powerful change. However, shepherding the ESG momentum across the organisation is dependent on the strong presence of good governance levers. Transparency and accountability must resonate with top management and leadership in order to effectively ensure the trickle down impact of ESG matters across employee cadres. The top must first 'walk the talk' by prioritising ESG sensitisation, performance and incentivisation at the board and leadership level. In the endeavour to further establish a work environment that is encouraged by incentivisation mechanisms, it is imperative to mainstream the ESG agenda at a nascent stage. Additionally, to accelerate the integration of ESG metrics across remuneration and reward mechanisms, there must be supplemental focus given to getting the 'G' factor of ESG right, in order for 'E' and 'S' to effectively follow suit.

For ESG goals and targets to be successfully achieved, accountability and action must

flow freely up and down the organisational structure. While long-term ESG ambition, strategy and targets must be established by leadership, initiatives and progress towards established ESG goals and targets must be communicated back up from operational teams. Each and every function across an organisation has a crucial role to play in embedding ESG across business activities as well as driving progress towards goals and targets. In order to effectively implement an ESG-linked incentivisation framework, accountability must be reflected within each function's roles. The incentivisation framework represents an opportunity to drive day-to-day achievements across ESG parameters and make the ESG journey more personal for each and every employee within an organisation. This also empowers employees to enhance their capabilities and excel in ESG performance. The framework below showcases the integration of ESG levers across employee cadres and the collective accountability that is required to achieve an organisation's ESG goals and targets.



5. Incorporating ESG Measures Into Executive Compensation Plans, Harvard Law School Forum on Corporate Governance, 2021

6. The power of pairing ESG and the employee experience, Harvard Law School Forum on Corporate Governance, 2022

A decorative banner featuring a central illustration of a hand holding a plant, surrounded by various icons representing sustainability, renewable energy, and ESG themes. The icons include a sun, lightning bolt, wind turbine, water drop, leaf, gear, recycling symbol, magnifying glass, factory, power plug, CO2, and a crossed-out factory. The text 'BIO' and 'ESG' are also present.

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