Evolving ESG metrics and employee compensation: The way forward

Board Leadership Center (India)
The evolving environmental, social, and governance (ESG) landscape has been stimulated by recent technological disruptions, unprecedented health crisis, mounting social disparities, and global climate crisis. Today, every organisation has embraced an ESG agenda to ensure responsible business practices throughout their value chain. The current approach looks far beyond the traditional ESG criteria and adopts financial metrics to bring sustainability as a critical evaluation parameter for employee remuneration. As forward-looking organisations delve deeper into ESG goal setting, they recognise employees are at the fulcrum of progressing organisations. Wherein, incentivising employees through integrating ESG into the payroll can potentially accelerate the company’s overall ESG agenda. Incentive plans which reflect the synthesis of ESG goals into them, harness the ability to align employee behaviour, actions and efforts towards the attainment of the company’s ESG objectives.

Previously, the ESG Council of KPMG in India’s Board Leadership Center (BLC) has shared perspectives on incentivising ESG linked performance. It highlighted how ESG metrics are rapidly making their way into corporate boardrooms and becoming a prominent component of incentivising C-Suite. This document furthers the discussion on ESG linked remuneration and delves deep into the ecosystem required for integrating ESG factors into the employee pay structure.

Decoding the maze of ESG incorporation into pay
Incorporating ESG metrics into incentive plans requires carefully designing and calculating achievable and palatable goals. In 2021, ESG-linked pay appeared as an emerging trend with companies deploying social and environmental metrics into their employee remuneration plans. As companies enter the unchartered waters of ESG linked employee remuneration, a robust action plan is required. The steps below aim to accelerate the effective integration of ESG through fostering an ESG culture, alignment with the company vision, stakeholder inclusivity and appropriate metric identification.

### STEP 1: Aligning with vision, mission and business strategy
Using company’s purpose, vision, and strategy, the ESG linked pay structure can be woven in the existing remuneration processes. The pay structures implemented by the compensation committee must be modified to be inclusive of ESG performance as well as the latest prevailing approaches in the ESG compensation landscape. The NRC will further be responsible for bringing structural changes and defining key responsibilities.

### STEP 2: Identifying the appropriate metrics
ESG metrics must be identified and tracked by the NRC to construct reward benchmarks and reinforce the company’s ESG strategy and culture. Employee compensation based on ESG metrics has a simple rationale: pay should be correlated with the efficiency that improves a business’s ability to create value for its stakeholders. However, for employee compensation plans to succeed, they must have precise targets supported by KPIs that align with the corporate strategy. When a company chooses to incentivise employee pay with non-financial ESG metrics, the metrics should be measurable and transparently communicated. It should be appropriately structured into the pay component either as short-term, long-term incentives or both, depending on the company’s goal and the sector it will be implemented in.

### STEP 3: Engaging with stakeholders
Companies must be cognisant of the varying perspective of their stakeholders to gauge whether they are on the right path. They must engage in thoughtful and cautious dialogue with internal and external stakeholders. Internally, the appropriate set of employees must be identified in order to garner their perspective on the identified goals and existing metrics. Their opinions are translated to the Board’s NRC which further designs appropriate mechanisms and incentive plans in line with the employees’ expectations of the ESG metrics. Companies can narrow down on the most important ESG metrics by conducting periodic materiality assessments and augmenting with stakeholder engagement initiatives.

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The framework below illustrates the steps for assimilating and expanding ESG metrics across functional levels of an organisation and tailoring the ESG journey for every single employee. The relevant role of the functional departments in implementing ESG and the specific metrics set for them are disclosed in the framework below which are illustrative in nature.

The material issues should be made relevant to specific departments/functions who can take the overall responsibility of its implementation. It is important to identify and task the roles and responsibilities of each functional department that are critical in improving the performance of the material topic.

Once the departments are identified, discussion with the functional heads will help in identifying the relevant KRAs (target) to be set on Y-O-Y basis in order to achieve the ESG objectives. The KRAs can be further enhanced and defined in a strategic manner based on its alignment with the department specific priorities. These quantifiable objectives should be discussed with employees and mapped to their skills and goal sheets in order to achieve maximum participation and transparency.

The NRC further plays a role in conducting awareness sessions and assigning weightages to the KRAs for respective departments across the organisation to drive the pay program effectively.

<table>
<thead>
<tr>
<th>Functional department</th>
<th>Research and Development</th>
<th>Operations</th>
<th>Human Resource</th>
<th>Operations and Customer Relations</th>
<th>Procurement</th>
<th>Engineering</th>
<th>Logistics</th>
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</thead>
<tbody>
<tr>
<td>Water</td>
<td>• Design products with an eco-conscious lens.</td>
<td>• Modify process requirements to practice reduce, reuse and recycle</td>
<td>• Develop policies which ensure equal remuneration, and address child labour as well as forced labour</td>
<td>• Maintain product safety and quality standards by ensuring adherence to governmental guidelines and regulations</td>
<td>• Develop sustainable procurement policies</td>
<td>• Optimising utilisation of resources during product development</td>
<td>• Ensure sustainable logistics to collect, segregate and recycle plastic packaging waste.</td>
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<tr>
<td>Human rights</td>
<td>• Modify product requirements for lesser water quantity.</td>
<td>• Drive Zero Liquid Discharge (ZLD) facilities.</td>
<td>• Conduct regular training on human rights</td>
<td>• Effective A/B and pilot testing of products before making them available to the general public.</td>
<td>• Supplier screening to drive the sustainability agenda across the value chain</td>
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<tr>
<td>Customer safety</td>
<td>• Achieve 5% of the target to become water secure.</td>
<td></td>
<td>• Enhance diversity and inclusion through policies and initiatives.</td>
<td>• Ensure zero incidents regarding cybersecurity breaches.</td>
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<tr>
<td>Packaging</td>
<td>• The company recycles &gt; 20% water (plant owned locations).</td>
<td></td>
<td>• Increase women diversity by 30%</td>
<td>• Achieve 15% of recycled content within the company’s plastic packaging</td>
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</tr>
<tr>
<td>Customer safety</td>
<td></td>
<td>• The company recycles &gt; 20% water (plant owned locations).</td>
<td>• Enhance the number of trainings conducted by 5%.</td>
<td>• Reduce the packaging-to-product weight ratio by 2%.</td>
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Proceeding with prudence

As organisations navigate through the growing momentum around ESG compensation, they may stumble across certain challenges for seamless implementation of ESG linked pay. Linking ESG measures and employee remuneration can be a robust mechanism and requires puissant measures to promote and implement change. To create an effective incentive design, companies should have trust in their metrics before integrating ESG goals into pay.

On the flip side of the coin, ESG linked pay program presents a myriad of benefits which can be availed for augmenting sustainable value creation. For companies that can endeavour a pre-emptive journey through the high tide of ESG remuneration will sail faster and for the rest, it will be a rough tide.

- Incentivise management teams to integrate material ESG goals into corporate agendas
- Help lessen scrutiny from investors, regulators, and other stakeholders
- Increase corporate value by putting less emphasis on short-term performance targets and more on long-term sustainability objectives
- Better accountability on sustainability-related performance across management
- Provides employees with a sense of purpose which correlates with higher job satisfaction and productivity

We would like to extend our gratitude towards the ESG and NRC council members for their valuable time, insights and perspectives that have contributed towards the development of this document.

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