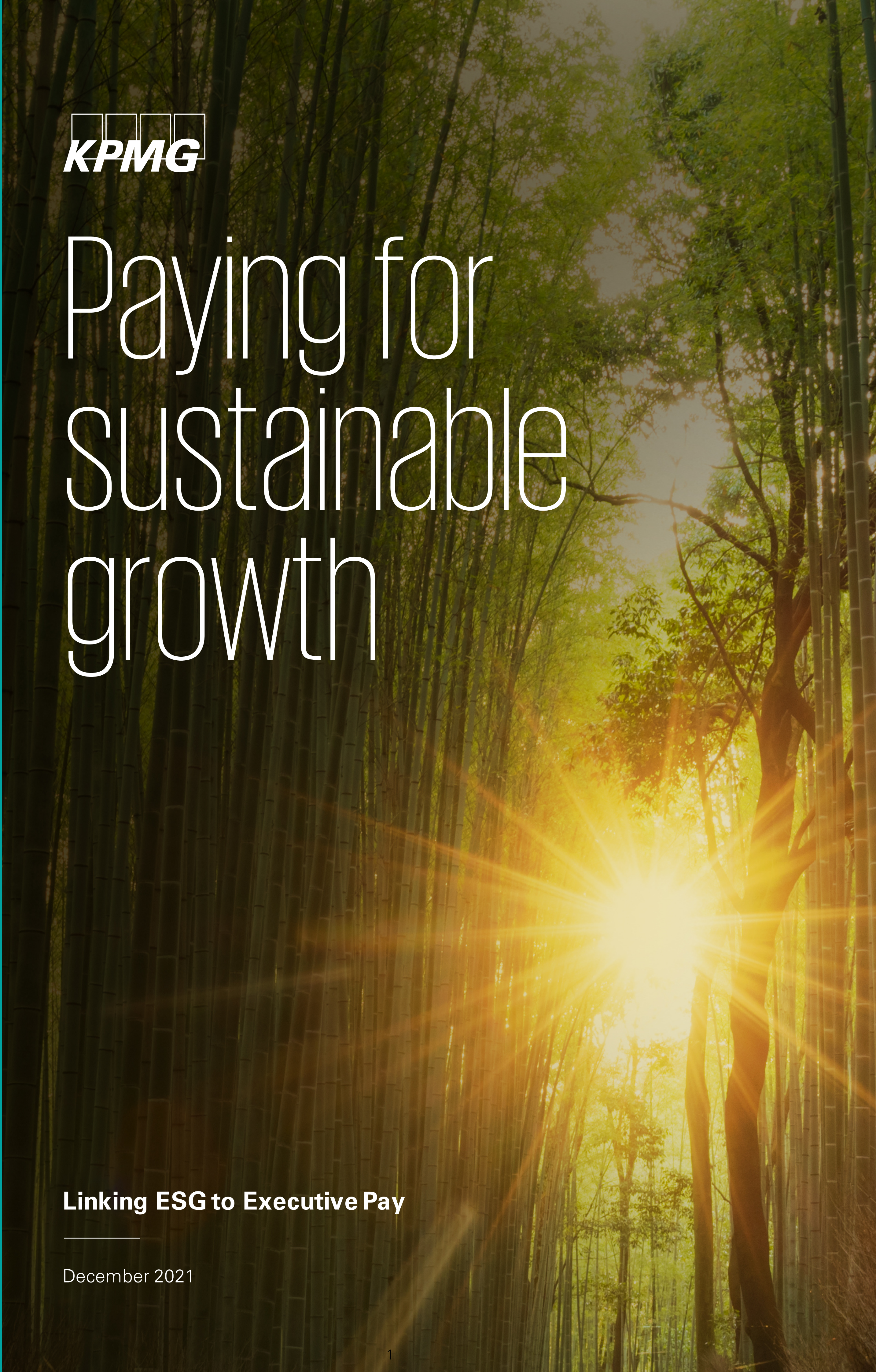


KPMG

Paying for sustainable growth

Linking ESG to Executive Pay

December 2021

Introduction

As focus on the ethical, legal and environmental issues related to business has increased, driven by growing concerns over areas such as climate change and diversity, so too has pressure on companies to address them. ESG (Environmental, Social and Governance) factors have become critical to good business practice and are tied to the success and long-term sustainability of companies across all sectors. While we continue to see more and more companies making long term sustainable growth the focal point of their strategy, there is emerging pressure from investors, regulators and other stakeholders to push this further and directly link ESG factors with areas of governance such as executive pay.

This paper sets out the current landscape of market practice and provides an overview of some investor opinion on ESG matters in the context of executive pay. It also provides KPMG guidance on key considerations for when and how you begin thinking about incorporating ESG measures into your own executive pay.

Our analysis is focused on FTSE listed companies only and is based on financial year ends up to 30 June 2021.

Linking ESG to executive pay – an emerging agenda

Regulators

In recent years, we have seen an increased focus on the ESG agenda from UK regulators.

From Q1 2021, all UK premium listed companies have been required to report on a 'comply or explain' basis in line with the recommendations of the Taskforce on Climate related Financial Disclosures (TCFD). The same requirement is extended to PRA regulated firms. The Treasury has also released a roadmap to mandatory disclosures for most listed companies and financial services firms with an endpoint of 2023.

Furthermore, the FCA is currently consulting on proposals to change the Listing Rules to encourage better disclosure of diversity on listed company boards and executive committees.

Given the increased scrutiny, new regulations and likelihood of further regulatory requirements in the future, it is essential for companies to stay ahead of the curve and ensure that relevant ESG factors are being taken into consideration when developing the business strategy. Remuneration committees therefore need to make sure that executive pay is supporting the ESG agenda and encouraging sustainable growth.

Proxy Advisors

Both ISS and IA voting guidelines are generally supportive of linking ESG to executive incentive pay.

IVIS specifically stated in their shareholder priorities 2021 that *'It is appropriate that a greater number of companies are incorporating the management of material ESG risks and opportunities into their long term strategy. In these cases, it is appropriate that Remuneration Committees consider the management of these material ESG risks as performance conditions in the company's variable remuneration.'* IVIS also recommend that ESG measures should be material to the business, quantifiable, and linked to the company's strategy.

Although specific ESG measures for executive incentive plans are not specifically discussed n the ISS UK and Ireland Voting Guidance, companies are advised to take into account ESG matters when applying discretion on the incentive pay-out.

Investors

A number of large institutional investors have also expressed their interest in companies relating ESG measures to executive incentive pay. Opinions range from general commentary on the importance of considering the ESG angle to specific recommendations regarding the method and extent of ESG measures. Cevian Capital[1] and Amundi[2], for example, recommend that the executive compensation package should be partially based on ESG factors, meanwhile some others put emphasis on the need for any ESG measures included in executive pay to be directly linked to shareholder value creation and sustainable growth.

Legal and General Investment Management[3] advise that companies with ESG risk should incorporate relevant and clearly measurable ESG targets in their executive remuneration. In the case of long term incentives, they recommend that ESG weighting should be no more than one third of the total award.

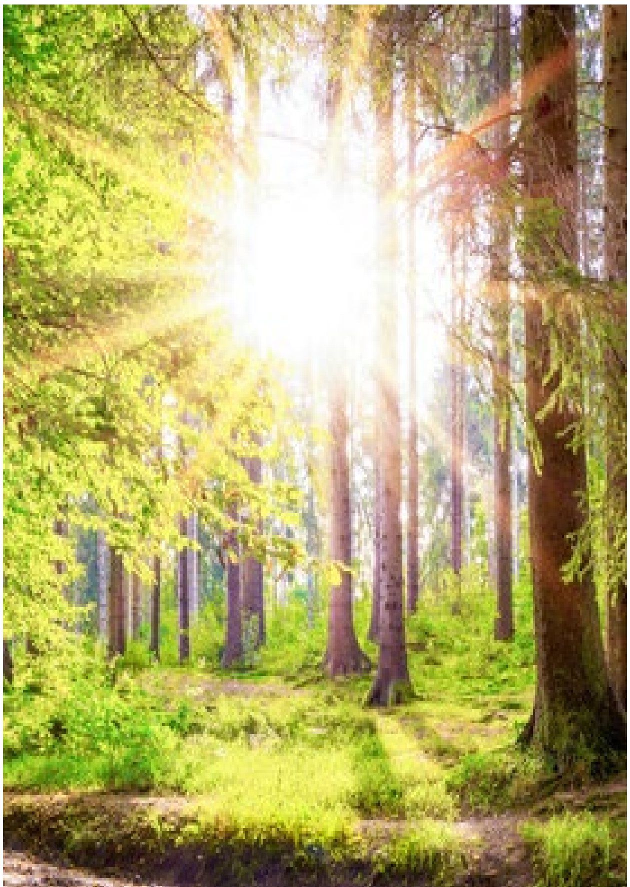
Whilst the perspective of 'how' to incorporate these measures is likely to vary between individual investors, we expect to see all investors continue to take an active interest in incorporation of these targets in coming years as media scrutiny and public interest in both ESG issues and executive pay grows, particularly in relation to environmental concerns and social equality.

Reference:

1.Cevian Capital Requires ESG Targets in Management Compensation Plans: Cases (ceviancapital.com)

2.Amundi 2021 Voting Policy: https://about.amundi.com/index.php/layout/set/popin/Sites/Amundi-Corporate/Pages/News/2021/Voting-policy-and-2021-engagement

3.UK Principles of Executive Pay LGIM



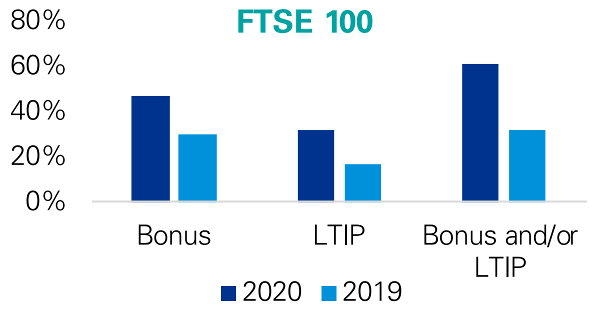
Linking ESG to executive pay – market practice

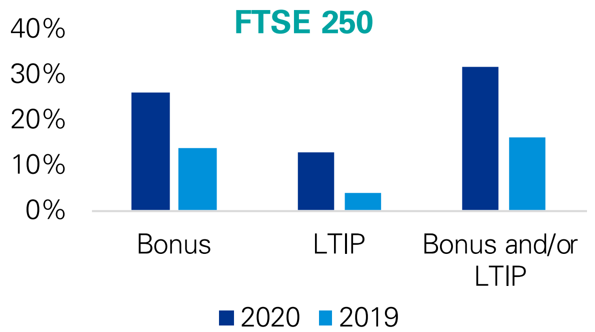
Prevalence

We have seen an increasing trend of FTSE listed companies incorporating ESG measures in their incentive plans. Among FTSE 100 companies, 61% incorporated ESG measures in their bonus and/or LTI plans, an increase from 32% from last year.

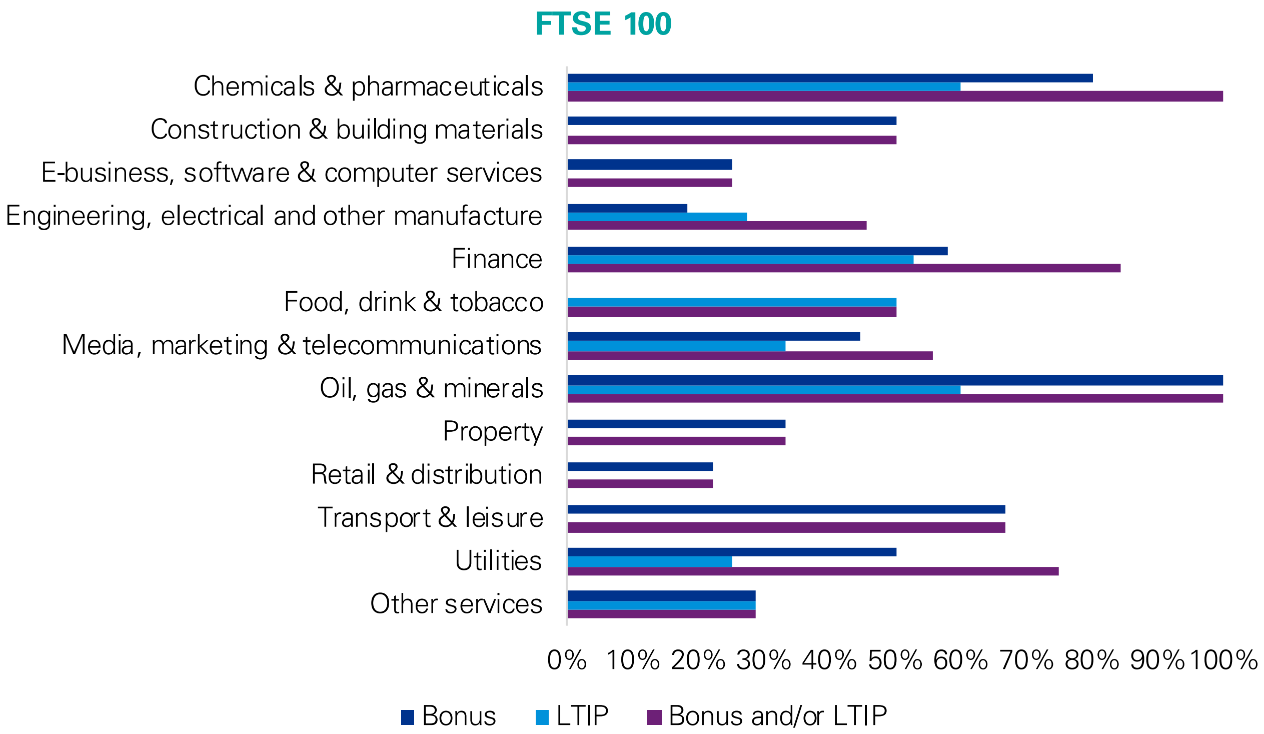
Within the FTSE 250, the prevalence was much lower, with only 32% of companies incorporating ESG measures in their bonus and/or LTI plans. However, this has doubled from 16% last year and thus reflects the general trend. Companies in the FTSE Small Cap appear to have been slow to respond, with only approximately 1% of companies having included ESG measures in their executive incentive plans.

It is also worth noting that there is a greater year on year increase in ESG measures in the LTIP than the bonus for both FTSE 100 and FTSE 250, which shows an increasing focus on the long-term nature of certain ESG measures and possibly the increased focus on net zero targets (which often extend beyond the end of any LTIP performance periods).





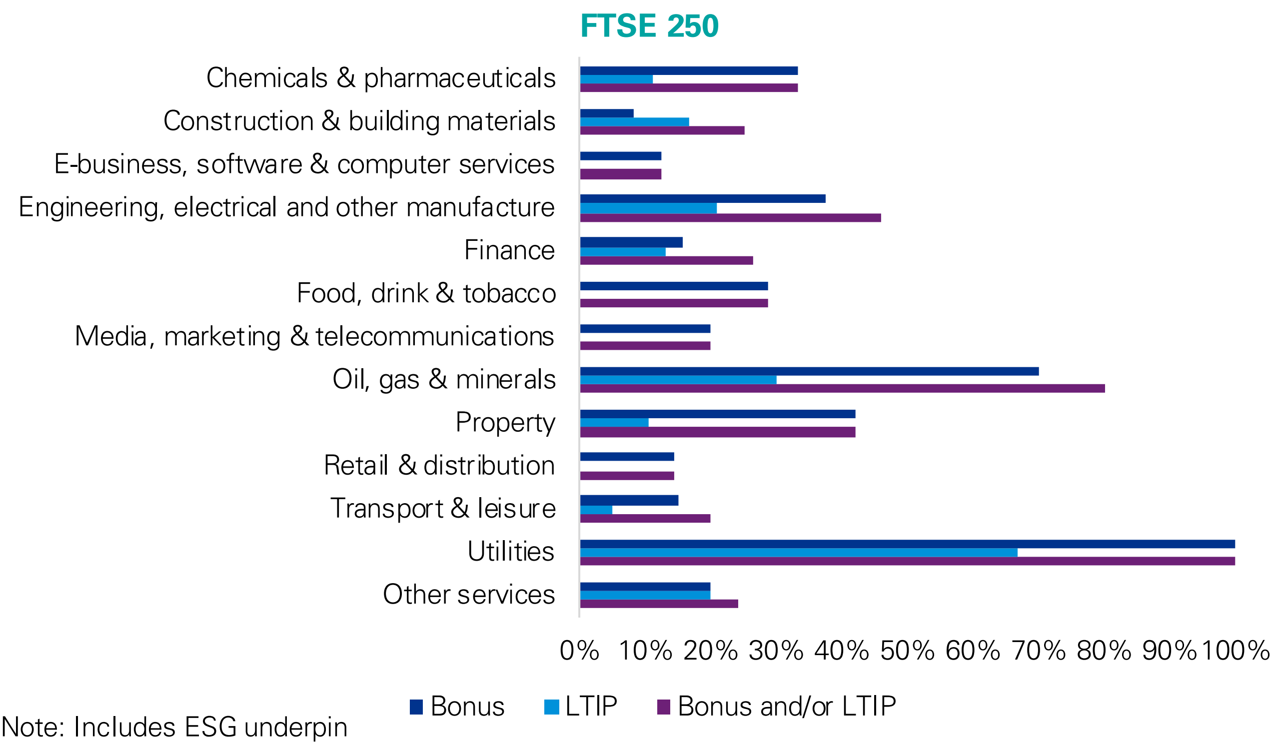
From a sector perspective, there are certain industries where we would expect to find a higher percentage of ESG measures, due to the nature of the business and traditional focus on the environment or health & safety, for example. This is indeed the case within the FTSE 100, where Oil, Gas & Minerals, Chemicals & Pharmaceuticals and Utilities have the highest rates of ESG measures in their bonus and/or LTIP. Conversely, Retail & Distribution and E-business, Software & Computer Services have the lowest.



Note: Includes ESG underpin

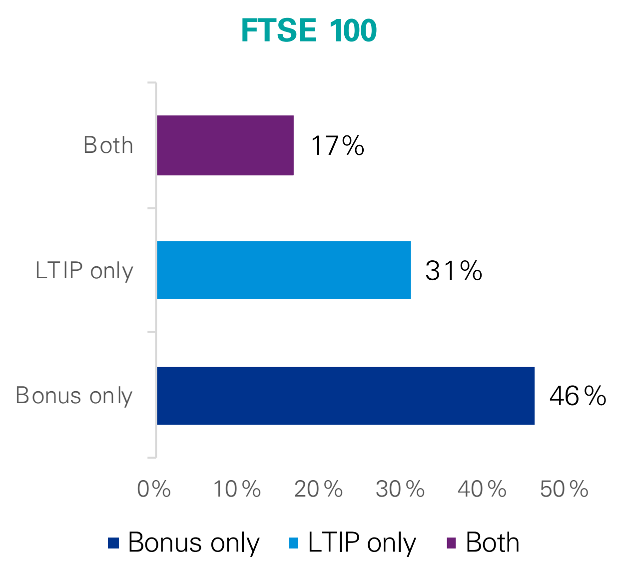
Similarly, Oil, Gas & Minerals, Chemicals & Pharmaceutical and Utilities are sectors with highest adoption rates of ESG measures within the FTSE 250.

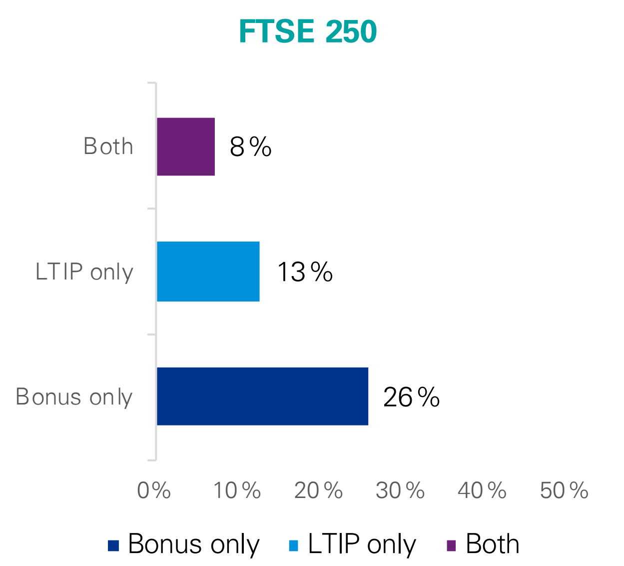
Interestingly, companies within the Finance sector have a very high ESG measure application rate within the FTSE 100 (at 84%), but a low rate amongst the FTSE 250 (at 26%).



Note: Includes ESG underpin

Based on our analysis, incorporating ESG measures into the annual bonus is currently a more common approach than inclusion within long term incentives. In many cases, this may be because it is easier to make changes to bonus targets, but also that bonus targets tend to sit more traditionally within the ESG sphere, for example measures linked to the societal element such as employee engagement, diversity and inclusion. Within the FTSE 100, 46% of companies incorporated ESG measures in their bonus plan, with only 31% choosing to include it in their LTIP. 17% of companies incorporated ESG measures in both bonus and LTIP. Within the FTSE 250, the pattern is much the same, with bonus the most popular choice at a rate of 26%, followed by LTIP on 13% and both at 8%.





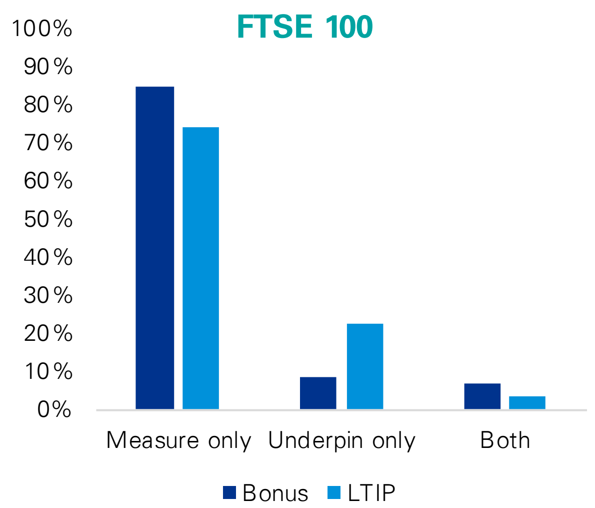
Please note, the remainder of the FTSE companies have either no ESG measures or have not disclosed any.

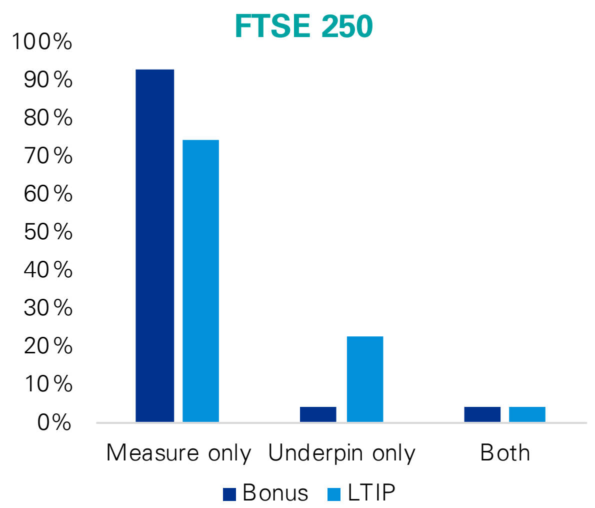
Implementation

In terms of implementing ESG measures into incentive plans, companies typically choose between introducing actual ESG measures with weightings or, using an underpin that affects overall outcomes. In the case of actual measures, targets tend to be specific and relate to individual aspects of ESG such as CO2 emissions. Where an underpin is applied, there is usually more of a general goal e.g. avoiding a negative ESG-related event. Our analysis shows that the vast majority of companies use measures rather than an underpin in both the FTSE 100 and FTSE 250, although a small number of companies use both.

A few companies incorporate ESG measures into a balanced scorecard instead or review ESG matters when exercising discretion. The debate around which measures fall under the ESG umbrella and lack of clear rules on how to disclose them leaves open the potential for mis-categorisation and thus exclusion from the analysis.

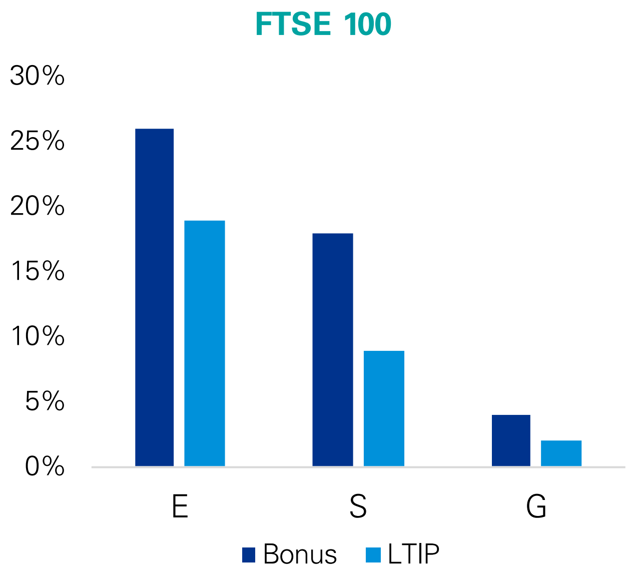
Our report only captures ESG measures that are either explicitly categorised as ESG or overtly relate to ESG but it is possible that companies have relevant measures elsewhere.

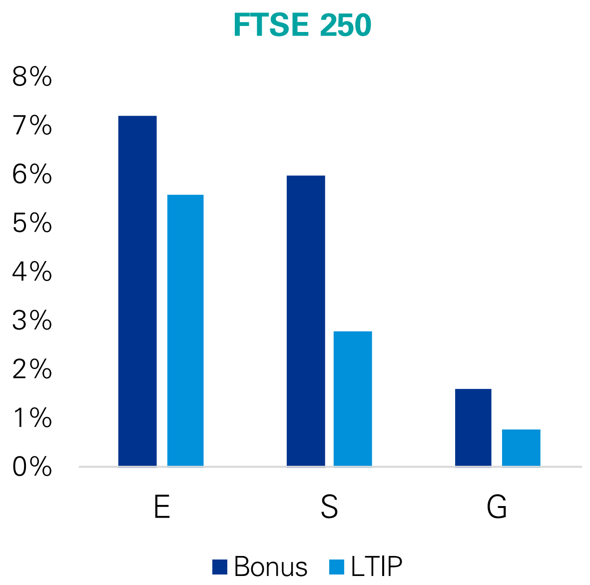




Measures and Weighting

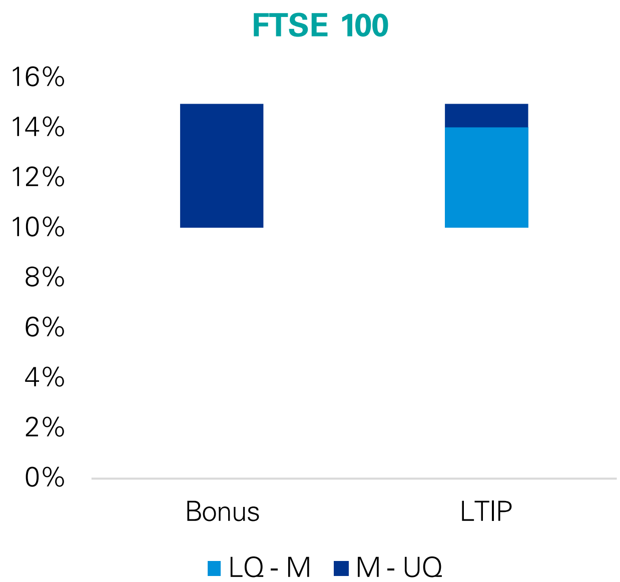
The most popular category of ESG for incentive measures is Environmental, followed by Social and finally Governance. This pattern is the same for both FTSE 100 and FTSE 250, as well as for bonus and LTIP.

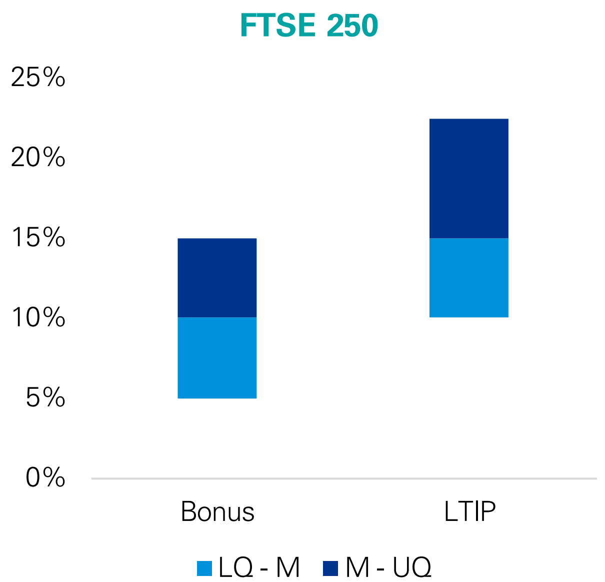




Weightings for ESG measures vary between FTSE 100 and FTSE 250.

In the FTSE 100, lower quartile (at 10%) and upper quartile (at 15%) are the same for bonus and LTIP. In the FTSE 250, however, weightings are higher in the LTIP.





As discussed earlier, there is no widely accepted definition of each ESG category and the measures that apply.

The table below gives some examples of commonly used measures under each category.

Environmental	Social	Governance
Emission Levels	Diversity & Inclusion	Corporate Governance
Sustainable Production	Culture	Shareholder relations
Energy Efficiency	Employee Engagement	Anti-bribery and corruption
Waste Management	Community	Board composition

Linking ESG to executive pay – where do you begin

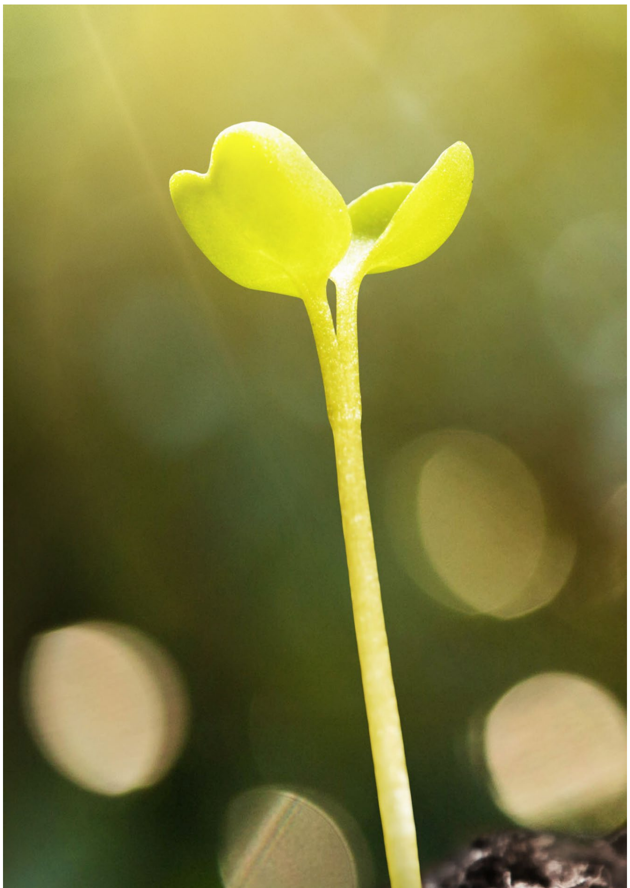
If your company is thinking about incorporating ESG measures into your executive incentive plans, below are some initial questions you may want to consider.

Do you need to include ESG measures in your executive incentive plans?

Overwhelmingly, the answer is yes. However, the first question you need to examine is what ESG measures are right for your business, and how these can be incorporated in a measurable way. It is of course important to understand what your peers are doing as well as the investor perspective - but more than that, it is crucial to understand your own ESG agenda and the measures for success.

In some cases, ESG may be strongly embedded in the company culture and strategy, and this value already embedded in financial measures that are already linked to executive pay. Decisions on KPIs and their relative weighting should take into account the risk of over-paying executives by linking unnecessary ESG measures, while also assessing the potential benefits to company performance, sustainability and reputation.

It may be that measures which would be considered 'ESG' are already in use, therefore it may be a case of reviewing and realigning those measures through a more specific ESG lens to make sure they are clearly aligned to strategy but also deliver on the critical aspects of the company's renewed purpose as well as clearly communicated to investors.



ESG for long term or short-term incentives?

If you have decided that linking ESG to executive pay is the right for your business, then the next question you may want to consider is which incentive plan(s) to use ESG metrics in.

Although most ESG matters are long-term in nature (normally longer than the performance period for long term incentive plans), you may be able to identify some shorter-term milestones that are measurable and appropriate for either incentive plan. It is important that the timeline of these milestones is aligned with the performance period of your incentive plans, and that the measures set up do not encourage unsuitable behaviors which distort the longer term ESG agenda.

Many longer term ESG milestones are likely to be beyond the performance period of even the longest LTIP performance period - and quite possibly beyond the tenure of the existing management team. However, making sure that management are both responsible and accountable for the steps along the way to the longer-term ambitions will prepare the way for a more linear and consistent strategy over the years.

How should you include ESG measures?

Once you have decided which incentive plan(s) you want to incorporate ESG measures into, you need to consider the different ways in which they can be introduced. Typically, there are four main ways to incorporate ESG into incentive plans: Underpin, scorecard, single weighted measure and through discretion.

There are pros and cons for each of these methods and investors normally have their own preferences. For example, ISS suggested that ESG matters could be assessed through application of discretion (although bearing in mind that listed companies now need significant disclosure on the basis on which discretion is exercised). Legal and General Investment Management stated specifically that they would prefer ESG to be incorporated in the form of weighted, clearly measurable metrics.

Based on our research, the most prevalent current market practice is using ESG as a weighted measure.

Which ESG measures should be incorporated?

One of the key challenges companies are facing when linking ESG measures to executive pay is deciding what measures to include. Our research shows that Environmental measures are most popular amongst the FTSE 350 but there is no correct single answer and the appropriateness of any given measure will vary depending on the nature of the business and your unique circumstances. Your chosen measures should align with your wider ESG agenda and fit into your overall business strategy. Investor views also need to be considered.

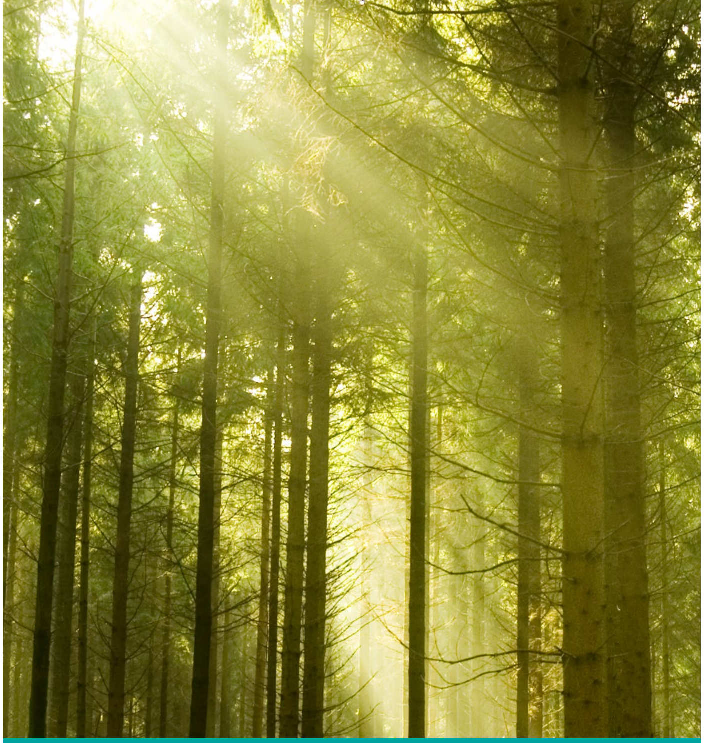
Once measures are chosen, suitable targets need to be set. Therefore, measures should be measurable and of relevance to the roles of the participants.

You can use the ESG metrics published by World Economic Forum (WEF) in 2020 as a starting point - the metrics focus on four pillars: People, Planet, Prosperity and Principles of Governance.

What is an appropriate weighting for ESG?

Should you decide to implement weighted ESG measures, you will need to carefully consider how much of the award this constitutes. There is no right or wrong answer when it comes to choosing an appropriate weighting; as with the measures themselves, this decision will need to be made in the context of your wider ESG agenda and business strategy. Typically, ESG measures have a collective weighting of around 10% -15% but range from 3% to 33.3% in the FTSE 350.

While ESG measures are increasingly important, getting your weightings right is a balancing act. Applying a larger percentage to your ESG measure(s) is not necessarily better, but they do need to be material in the overall context of the executive remuneration package. Companies need to be mindful of other performance measures and their weightings and how ESG fits into the overall incentive plan.



Conclusion

ESG is clearly an area of growing focus and is here to stay. By linking performance related pay, businesses are showing their commitment to long term sustainability and their intention to encourage their executives to be the driving force in advocating ethical behaviors, creating an ESG aligned culture from the top down, and ensuring that they personally take into account the ESG impact of any decisions they make.

Our results show that ESG is becoming a vital component of reward strategies across the FTSE 350 and we expect it to remain so over the longer term.

Contact Us

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