INCENTIVIZING WHAT MATTERS

Designing Meaningful ESG Metrics for Executive Compensation

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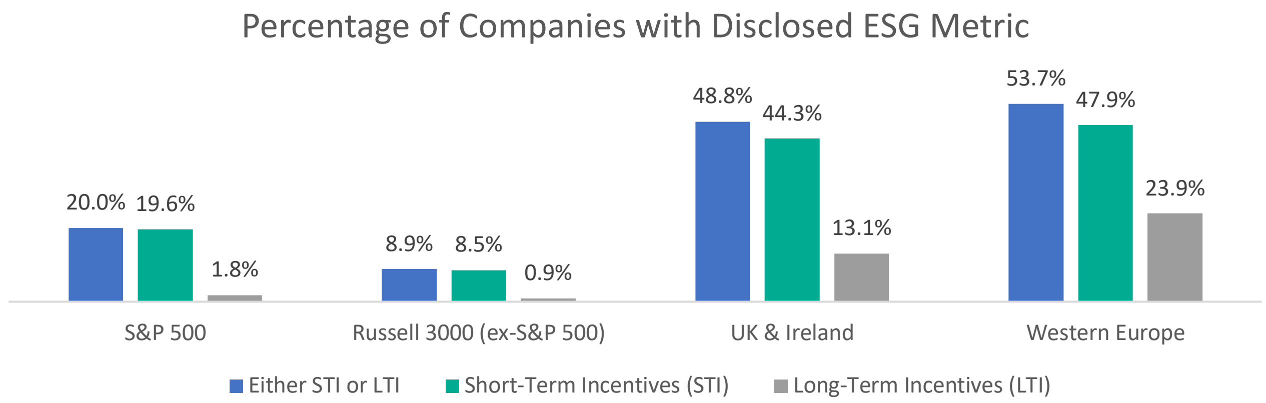
INTRODUCTION

Environmental, Social, and Governance (ESG) considerations are impacting various facets of what investors and companies do, and this impact now includes executive compensation. In just the last few years, ESG has taken off in ways that assertively refute any doubts about it being just a passing fad. Incorporating ESG factors into the investment process is quickly becoming the norm, and investors' expectations are evolving from short-term profit maximization to sustainable value creation. Funds and ETFs specifically denoted as "ESG" reached record levels of assets under management (AUM) in 2020, with collective AUM represented by Principles for Responsible Investments signatories reaching $121.03 trillion globally[1] and US-domiciled AUM using sustainable investing strategies increasing by 42% from $12.0 trillion in 2018 to $17.1 trillion in 2020[2]. Against this backdrop, companies are starting to incorporate sustainability into their corporate strategy and rethink the way executives are being incentivized. This paper examines the current state of ESG metric utilization, provides an overall framework for identifying material ESG factors, and offers thoughts on how to incorporate them into executive incentives.

ISS data shows that a significant number of companies now have a portion of executive compensation linked to their ESG performance. Incorporating ESG factors into executive pay is most prominent among European and U.K. companies where approximately one-half of companies have disclosed ESG metrics in their executive compensation program. In comparison, 20% of S&P 500 and less than 10% of Russell 3000 companies (excluding S&P 500) have disclosed ESG metrics in executive pay. These figures likely underrepresent the number of companies with ESG metrics in their executive compensation program as only clearly disclosed ESG metrics that are sufficiently distinct from others are counted as an "ESG metric" in ISS data. In addition, many companies may have ESG metrics in their executive compensation program, but do not necessarily disclose the details. For example, ESG metrics often appear as a bullet in a laundry list of individual performance objectives without sufficient detail regarding what they measure and what the targets are, if any. These typically would be categorized by ISS as an "individual performance" metric as opposed to an "ESG" metric.

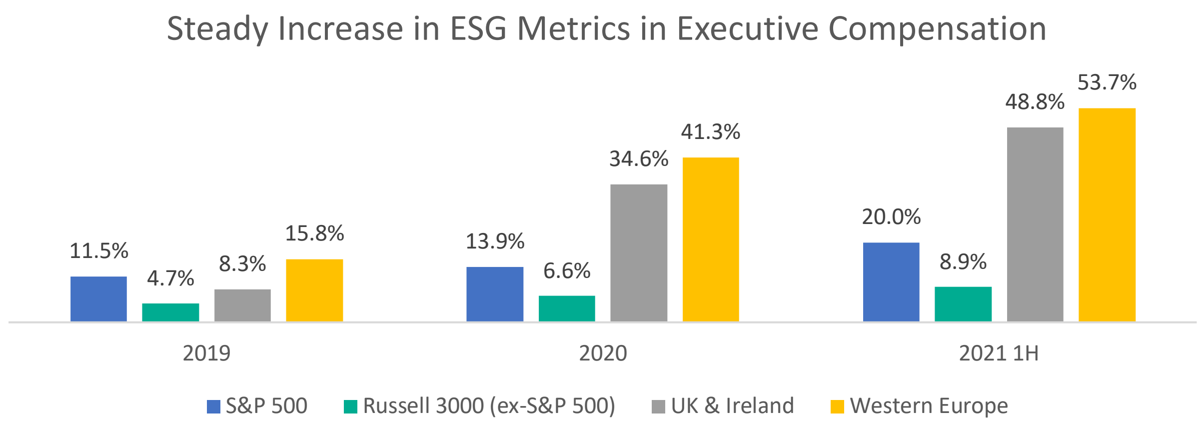
[1] PRI Update, Q3 2021

[2] US SIF Foundation, "Report on US Sustainable and Impact Investing Trends, 2020"



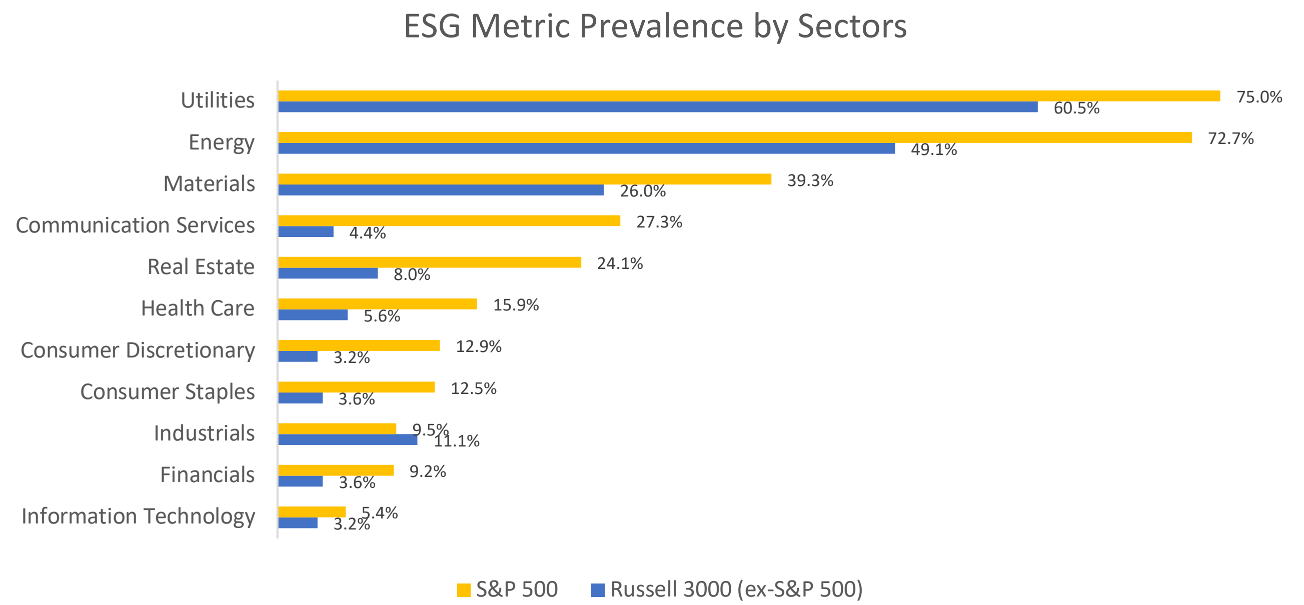
[3]

ESG metrics in executive compensation are steadily gaining steam among companies. In 2019, 11.5% of S&P 500 and 4.7% of Russell 3000 had ESG metrics in either their short-term incentives (STI) or their long-term incentives (LTI). This has nearly doubled to 20% and 8.9%, respectively, by June 30, 2021. Over the same period, their use increased sixfold in the U.K. and Ireland and by almost forty percentage points in Western Europe. While the rate of ESG metric adoption in the U.S. is slower than in Europe, the pace seems to be increasing. It remains to be seen whether the use of ESG metrics will continue to spread at a faster pace, but as investors' demand for ESG integration increases, the trend likely will continue in the foreseeable future.



When broken down by industry we find that the Utilities, Energy, and, to a lesser extent, Materials companies lead the way in adopting ESG metrics. These industries have a significant environmental footprint and social responsibilities, and ESG factors can materially impact the performance, valuation, and viability of companies in these industries. Thus, it comes as no surprise that ESG metric adoption is more prevalent among these industries. It is also worth noting that other sectors that have a relatively higher level of ESG metric adoption – Communication Services, Real Estate, and Health Care – have significant social responsibilities.

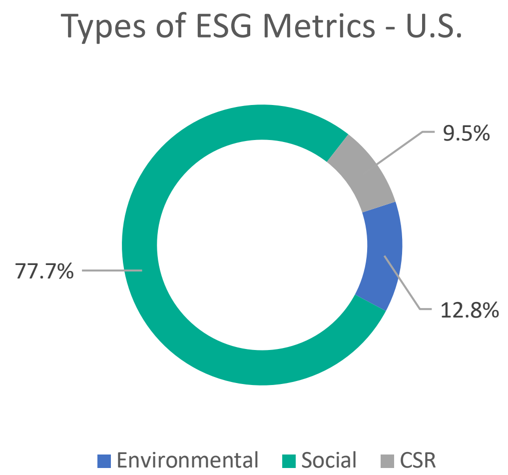
[3] Source: ISS Governance QualityScore, Q394 and Q395. Data as of June 30, 2021.

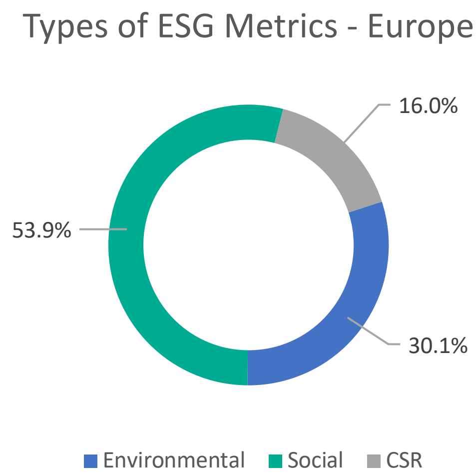


What ESG factors a company measures can vary greatly from company to company. Among U. S. companies, by far the most common type of metrics are those related to Social factors, particularly Human Capital Management (HCM) issues such as employee health and safety, employee engagement, and diversity and inclusion. There are a number of possible explanations for this. The global pandemic caused by COVID-19 likely has heightened the importance of employee wellness for many companies. The Black Lives Matter movement put the spotlight on inequities that exist in our societies, making diversity and inclusion a top priority for boards. Staff safety has long been a key area of focus for companies in the Utilities and Energy sectors and many firms in these sectors historically have had executive pay partially linked to employee wellness and training. Unlike many other ESG measures, HCM data is often more readily available for business leaders due to EEO-1 reporting requirement and as many companies have internal measures of employee engagement, training, and safety. HCM arguably is material to virtually all companies, and thus it intuitively makes sense that many companies choose to incentivize executives to manage and enhance their human capital.

There is also a notable difference in what ESG metrics are used among U.S. companies and European firms. 77.7% of ESG metrics measure Social topics in the U. S. whereas in Europe, there is a more even split between Social and Environmental metrics. In Europe, 53.9% of metrics are on Social factors, 30.1% on Environmental issues, and 16% on broad sustainability concerns (the CSR metric in the chart below). In the U. S., Environmental factors represent 12.8% of the metrics and CSR 9.5%. This may be due at least in part to greater adoption of carbon disclosure and emission reduction targets in Europe where 64% of European firm have disclosed GHG emission reduction targets compared to only 25% in the U. S.[4] European firms are more likely to measure, report, and set targets for their climate impact compared to U. S. companies. As climate reporting becomes more widespread in the U. S., more and more companies may start incorporating metrics tied to environmental topics in their executive pay.

[4] Based on ISS Environmental & Social QualityScore data.





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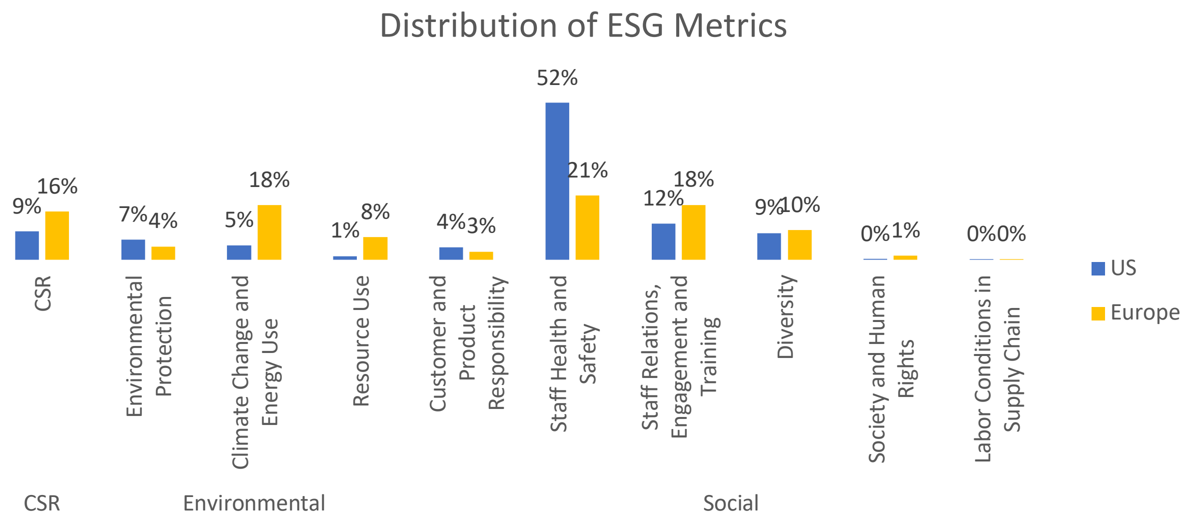

If designed effectively, aligning executive pay with ESG responsibilities could reinforce and incentivize management oversight of ESG. These ESG metrics could also serve as a signal, communicating to investors and stakeholders which ESG topics are the most important for management to focus on, and which priorities are driving its ESG performance, goals, and initiatives. Management would have a clear mandate to tackle ESG related business challenges that are most important to the company.

The initial challenge for companies in designing effective ESG metrics is to implement systems for determining which ESG topics and risks are most material to them. Just as with any other performance metrics, ESG metrics should be material to the company and be aligned with the company's ESG strategy. Materiality assessments could serve as a useful tool to clearly identify the topics or issues that are most salient to the company's specific business.

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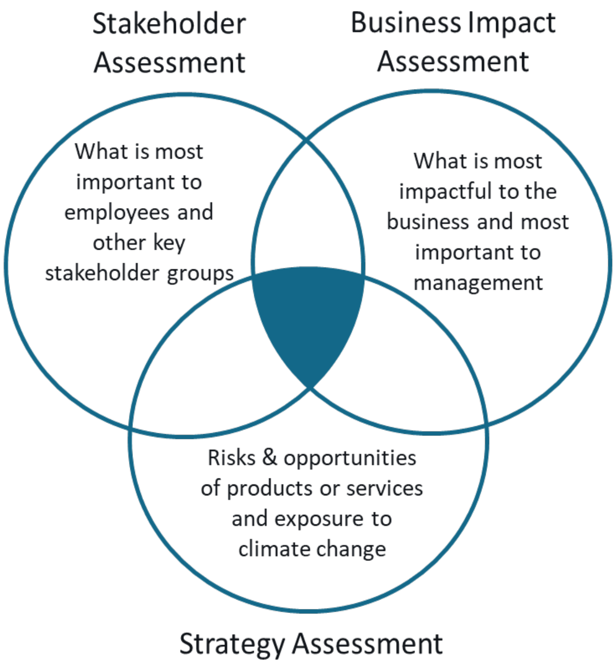
[5] Source: ISS Corporate Solutions Incentive Lab, Data as of June 30, 2021.Incentive Lab covers over 2,600 U.S. companies and 500 European companies, including U.K.

Materiality assessments allow companies to fully examine environmental and social impacts to their unique business model and operations. This process can take various forms, but ultimately there are several key elements that all materiality assessments should address. Ultimately, the goal of materiality assessment is to: determine both the internal and external ESG priorities, concerns, and drivers of multiple stakeholders; identify where critical risk exposure areas and opportunities require the most attention; and ascertain industry position and alignment within broader market frameworks.

STAKEHOLDER IMPACT

The focus of this component in the materiality assessment process is to identify relevant interested parties to the company outside of management such as employees, customers, suppliers, NGO's/industry groups, and/or regulators; and determine which key ESG topics are of most concern to them. Stakeholders can provide invaluable insight into what a company ought to prioritize.



FRAMEWORK ALIGNMENT

Investor expectations warrant their own step. Utilizing rating agencies' information and industry reporting standards can help identify what investors consider are the most relevant and material factors. These frameworks can also help benchmark companies' ESG practices against other industry competitors to identify areas where the company's practice excels against its peers or lags behind them.

RISK ASSESSMENT

Companies should evaluate what risks its businesses are exposed to, how such risks may impact their operations, and whether they have sufficient system to oversee and manage them. The Task Force on Climate-related Financial Disclosures (TCFD) calls for assessment of risks related to transition to a low-carbon economy and risk related to physical impacts of the climate change on the company's business. Cyberthreat is increasing as the digitization of the economy accelerate and many companies are starting to recognize information security as a material issue. An ESG risk assessment can be more valuable if a company can then determine where they measure in relation to other industry participants. If a critical ESG factor has been identified as industry and business specific, and a company is clearly a laggard or out of alignment with broader industry and stakeholder standards and expectations, then it may be appropriate to prioritize such factor and align executive key performance indicators (KPIs) to help manage and improve the situation.

When designing ESG metrics, companies should also take into consideration how such metrics should be measured and ultimately disclosed. Investor preference generally is for companies to utilize quantifiable and measurable ESG metrics and clearly disclose why they believe these ESG factors are most material to them, and how ESG metrics would incentivize executives to achieve ESG goals.

ESG metrics can be extremely challenging to measure, and this may deter some companies from incorporating ESG metrics into executive pay or lead them to adopt one without any clear goal or measurement. To allow for a meaningful and objective measurement, an ESG metric should be clearly defined as to what it measures, and companies would need to implement a system to collect data, measure progress, and assess impacts. Take for example diversity. What "diversity" means can be different depending on who you talk to. Diversity could mean gender, race and ethnicity, sexual orientation, and physical or mental disabilities. Another key consideration is diversity on what basis. That is, are you measuring "diversity" employee as a percentage of global or regional employees? Women as a percentage of managerial role? Or diversity employee as a percentage of new hires and promotions?

Verizon, for example, utilizes three ESG metrics in its fiscal 2020 executive compensation: workforce diversity, diverse supplier spend, and carbon intensity reduction.[6] Workforce diversity metric tracks the percentage of U.S.-based workforce who are women or minority and sets the target at 59.3%. Under the supplier diversity metric, at least $5.7 billion of supplier spending should be directed to minority- and female-owned firms for 2020. The company defined the carbon intensity as the amout of carbon its business emits divided by the terabytes of data transported over its networks, and targeted 10% reduction.

Investor expectation is that there are measurable and objective goals that are demonstrably rigorous yet attainable and are clearly aligned with the company's broader sustainability strategy. Disclosure of ESG metrics should be accompanied by the board's broader value narrative to shareholders and other stakeholders, and outline the company's particular challenges and achievements as they relate to ESG KPIs.

Here are some practical tips in designing, measuring, and disclosing ESG metrics:

- As a part of multi-stakeholder materiality assessment, companies are encouraged to engage with multiple stakeholders, including of course shareholders. The stakeholder engagement section of a proxy can be expanded to include a discussion on ESG engagements and feedback and inputs received, and how they impacted ESG metric selection. Seek inputs, track their impact and influence, and disclose.
- For some metrics, benchmarking the goal versus peers or established standards may ensure that the goal is challenging and relevant to a company's industry or business. There are various resources available to companies to track, measure, and assess their ESG practices. Depending on a company or industry, it may be appropriate to build a separate peer group for this process to better reflect the company's sustainability challenges. It would, of course, be important to explain why a separate peer group had been built and why it was considered more appropriate than existing performance peer groups.
- Does the award design capture payout versus level of goal attainment? ESG metrics should follow the same basic principles of sound compensation program. That is, goals should be sufficiently challenging, and the payout should reflect performance. Keep in mind that investors would want to see these goals and how the company performed against them.
- Companies will also need to assess any quantifiable component to limit any ambiguity about goal attainment, progress made year over year, and the appropriateness of the goal's weight within the program. Data collection, measures of progress, and impact assessments maintain alignment with the broader sustainability goals of the company.

[6] Source: Verizon Communications, Inc. 2021 Proxy.

- One important consideration is whether to incorporate ESG metrics into STIs or LTIs. Many ESG issues are long-term in nature, but an overwhelming trend is to have ESG metrics in STI instead of LTI. This trend may be related to the perceived difficulty of measuring this new set of metrics over the long-term. Similar to how STIs often have strategic objectives that could have long-term implications on the company's business, many companies are incorporating ESG metrics as short-term business objectives with long-term implications, while a small minority of companies are setting multi-year ESG targets that tracks long-term strategic objectives. Obviously there are choices, and companies should be careful to explain why they have chosen to measure ESG performance in the short-term and how that alings with long-term value creation.
- The compensation committee will also need to consider to what degree ESG metrics should impact executive compensation. The average ESG metric weight is around 10%, and typically ranges between 5% to 20%. However, the appropriate level of weighting may depend on the nature of the company's business, its ESG risk exposures and opprotunities.

Designing meaningful ESG metrics is a journey that involves multi-stakeholder engagement, materiality assessment, ESG strategy development, ESG data collection, ESG and compensation benchmarking, impact assessment, and proxy disclosure. ISS Corporate Solutions (ICS) has developed a suite of solutions to support companies in each of these steps. Our Sustainability Special Project team can conduct materiality assessment using data-driven, and forward-looking approach to not only identify ESG risks, but opportunities as well. ICS' newly launched Climate Analytics module offers companies unprecedented access to climate-related data and analytics, enabling companies to quickly measure, track, and benchmark their greenhouse gas emissions, disclosure practice, risk levels, alignment with various reporting standards, and other climate-related metrics and indicators. Our Executive Compensation solutions combine data, analytics, and expert advisory to optimize the design and communication of your executive compensation program. Incorporating effective ESG metrics into executive compensation can be a challenging task, but ICS data, analytics, and advisors can empower companies to establish ESG metrics that appropriately incentivize executives to create value sustainably while meeting investors' expectations.