ESG by Default

A Gamechanger for Strategy, Governance and Remuneration?

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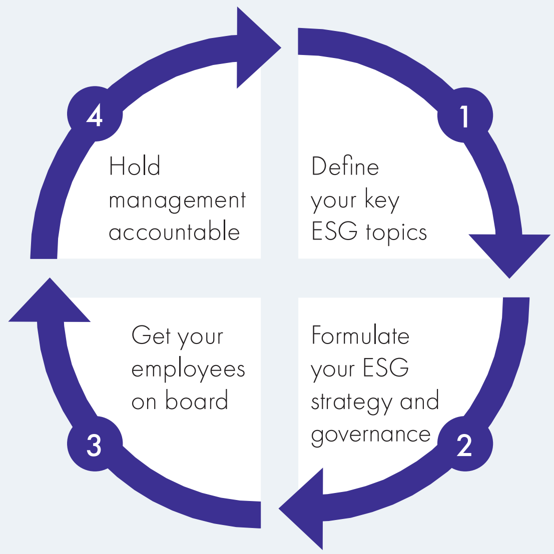
The current situation has once again demonstrated how critical it is to integrate environmental, social and governance (ESG) topics in the long-term corporate strategy. In fact, first studies have indicated that during the COVID-19 pandemic, companies with a high ESG score had a better performance than, for instance, the S&P 500 Index[1]. Apart from the observed stock price outperformance, stakeholder pressure - owing to regulatory developments and expectations by investors, customers, and society - on companies regarding a more coherent and stringent consideration of ESG concerns is increasing.

The actual application of ESG, however, often leaves companies unsure about how to anchor these topics in their strategy, governance, and – especially – remuneration practices. The question arises as to how organizations can warrant the achievement of strategic ESG goals. How can Boards of Directors and Executive Management independently form an opinion on ESG topics? And lastly, how can progress be measured and incentivized?

HCM International conducted an explorative study on the Swiss financial services industry, which is one of the Swiss key economic sectors. In our view, however, these findings are applicable to other sectors as well. The study conducted is based on the top 25 companies in the SPI Financial Index and is supported by interviews with selected CEOs and Chairmen. Based on our findings, there are four key steps for a successful ESG implementation:

1 See e.g. GRIST. «As coronavirus infects markets, sustainable funds prove their mettle», March 23, 2020. Accessed June 11, 2020, under https://grist.org/energy/as-coronavirus-infects-markets-sustainable-funds-prove-their-mettle/



1 Define your key ESG topics: Conduct an ESG focus process and define current gaps

One of the main struggles faced by ESG-related initiatives is the diversity of definitions of ESG and the very wide range of relevant issues. The conducted interviews showed that these challenges were often perceived to be based on a «lack of an ESG code of conducts» or a «diverse level of strictness» in this «very broad topic». Therefore, defining an organization's key ESG topics and subsequent initiatives by means of a materiality assessment constitutes a helpful first step.

Such assessments are based on internal and external stakeholder feedback and vary depending on industry, business model, strategy, and culture. For most companies, materiality assessments form a key step towards the definition of focus topics as well as shaping a common language within the company. However, of the financial service companies analysed, only 52% published a materiality assessment, which usually mainly focuses on social (100%) and governance (85%) topics.

Identifying what these topics mean for companies – not only in terms of external products and services but also regarding internal processes – is challenging yet essential for defining an organization's ESG approach.

2 Formulate your ESG strategy and governance: Ensure appropriate processes

Companies often struggle to derive concrete strategic ESG goals and initiatives. While the definition of a long-term ESG strategy is ideally part of the responsibilities of the Board of Directors, only 36% of the analysed companies disclosed that they discuss ESG with the whole Board. Furthermore, approximately 28% published having a separate Board committee on ESG in place. At the executive level, 52% of the companies disclosed pursuing an active management of ESG topics. To ensure the right «tone from the top», ESG needs to be anchored in the regular strategic cycle enabling the successful implementation of ESG initiatives through prioritization and clear communication cascaded throughout the organization.

3 Get your employees on board: Communicate the benefits of ESG

Often faced with insecurity and questions from employees such as «Are we no longer allowed to fly to business meetings?» or «Are we banning meat in our staff restaurant?», organizations are increasingly encountering the need to engage employees in their ESG journey. Bringing employees on board at an early stage is essential for fostering organizational support and commitment. In this regard, some of the interviewed companies are promoting a bottom-up approach. Such an approach, however, needs to be based on sound strategy and governance processes to support implementation initiatives and be perceived as a priority by the broad company population.

4 Hold management accountable: Track progress and link ESG to remuneration

Though accountability regarding ESG is also related to measuring and tracking progress, remuneration remains an important aspect to ensure prioritization and foster credibility. In fact, investors and proxy advisors are increasingly reviewing remuneration systems for the reflection of ESG topics. In Switzerland, 30% of the top 100 companies[2] disclosed a link of ESG to variable remuneration – all reflected in the short-term bonus, not in the long-term plans. This sounds counter-intuitive as ESG is indeed a long-term topic but related to one of the main challenges: finding reliable KPIs and measurement methods. To overcome this issue, ESG topics need to be broken down into long-term strategic goals supported by concrete and achievable yearly and mid-term targets. This renders the impact of ESG initiatives visible and anchors them in corporate communication and culture.

Regarding the question where ESG is integrated, two fundamental approaches can be distinguished:

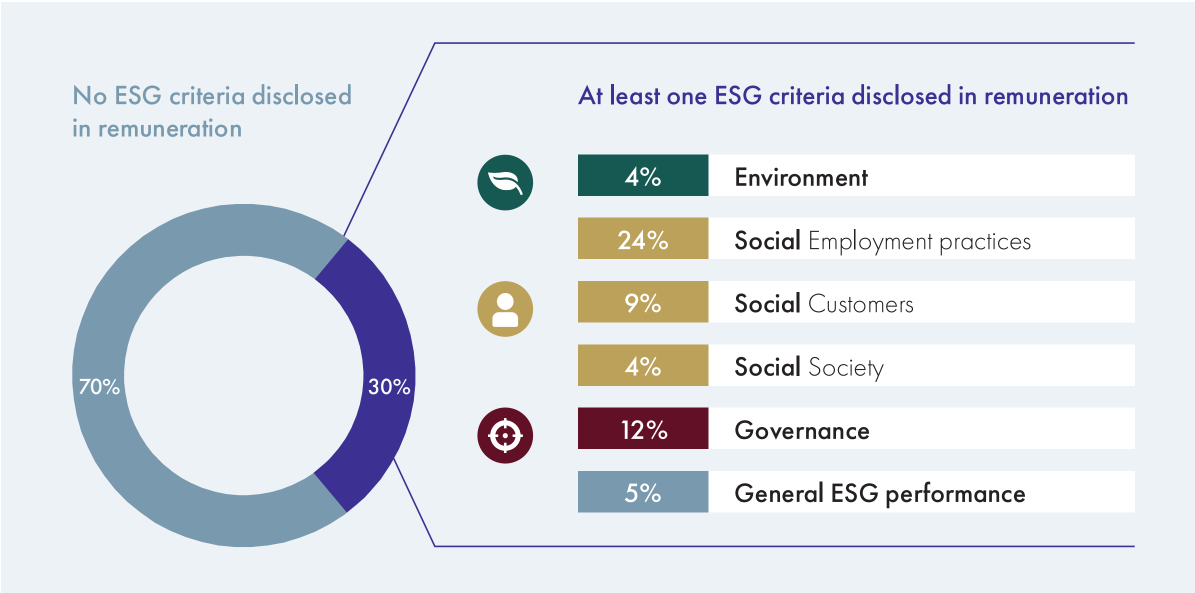
- Inclusion of ESG as part of the individual scorecard or
- Reflection of such topics at the level of the group or divisional bonus pool definition.

Regarding ESG topics reflected in remuneration, the analysed companies mainly use social topics with a special focus on employment practices (e.g. talent management or behaviour), followed by governance considerations and customer topics.

Companies establishing ESG criteria in their remuneration strategy tend to make around 10-20% of variable pay subject to ESG performance. Even though this seems «low» compared to financial targets (which typically constitute around 60-80%), it is still an important signal, showing commitment, accountability, and presence in this subject.

Overall, ESG has gained an enormous momentum over the last years. Boards of Directors are confronted with the topic by their shareholders as well as by their clients and employees. Though more progress is being made in this area, recent work has shown that allowing for sufficient discretion and Board oversight regarding ESG progress is necessary for such a system to work effectively. This is especially true when it comes to rather mechanical pay frameworks where trade-offs between criteria are often unavoidable. In those cases, room for judgement is sensible or, as a Chairman of a large insurance company put it: «If you think in trade-offs, you are not convinced.»

2 Source: HCM database. Based on currently available information.


No ESG criteria disclosed in remuneration
70%
30%
At least one ESG criteria disclosed in remuneration
4% Environment
24% Social Employment practices
9% Social Customers
4% Social Society
12% Governance
5% General ESG performance