Reward the talk – Pay for Performance includes Performance on ESG

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1. Summary

The regulatory requirements and pressure by stakeholders as regards sustainability has continuously increased in the past years. The efforts made by companies are constantly growing and translating into the expanding use of ESG metrics also in executive compensation. Nevertheless, challenges emerge both globally and domestically, in Switzerland, as the implementation and reaching of these goals raises questions regarding the use of metrics in variable compensation plans and how to address misalignment between financial and non-financial metrics.

2. Say-on-Sustainability puts pressure on companies

Stakeholders increasingly demand higher commitment from companies to make meaningful progress on sustainability. At the same time, regulatory pressure rises globally as well as in Switzerland. For example, as of financial year 2023, Swiss listed companies as well as banks are obliged to publish a sustainability report on their sustainability performance and initiatives which is subject to shareholders' vote at the AGM 2024 for the first time. While some companies are still starting to act, stakeholders including investors and proxy advisors have already expressed dissent over corporate ambition levels, for example on Board's gender diversity, as also reflected in specific voting results during the last proxy seasons.

3. Embedding ESG in compensation: a growing trend

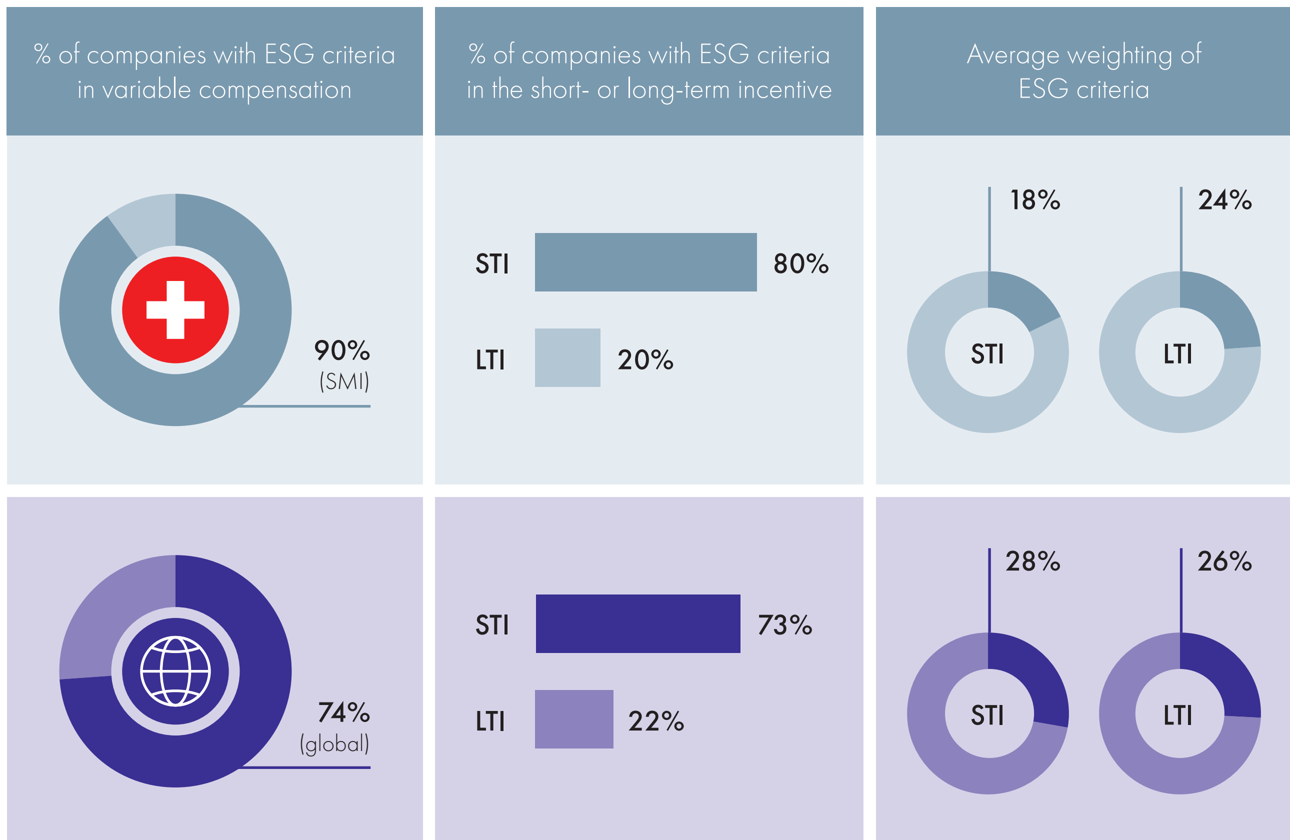
Until recently, variable compensation was typically linked to financial as well was individual performance. However, proxy advisors and investors set rising expectations to include non-financial performance, including sustainability. One way to show commitment to internal and external stakeholders and avoid criticism regarding «greenwashing» and low credibility is to reflect environmental, social, and governance (ESG) performance in executive pay decisions.

In fact, more and more companies are integrating ESG topics in short-term incentive plans (STI). A 2022 study conducted by the HCM presided Global Governance and Executive Compensation Group (GECN) found that among over 500 international companies, 73% use ESG in their STI (2021: 71%). In comparison, listed companies in Switzerland are still lagging with only 34% of the companies in the Swiss Performance Index (SPI) reflecting ESG in pay decisions. Our studies show that companies with larger market capitalization are more likely to employ such metrics, which also applies for Switzerland (90% of companies in the Swiss Market Index (SMI)).

The average weighting of these criteria within the respective STI plans makes up for 28% on a global level, 16% for SPI and 18% for SMI companies. Again, larger companies tend to put a slightly higher weight on ESG criteria within their compensation decisions. Notably, companies with non-financial incentive metrics show a higher historical total shareholder return (TSR) performance compared to market.

However, the prevalence of integrating ESG in variable compensation plans can vary significantly by industry. For example, some industries with already high prevalence of ESG metrics continue to see growth such as the utilities and materials sectors and reach approximately 95% of companies, while the energy sector is stable at around 85%. All other industries, with the exceptions of the financial and information technology sectors, see significant annual growth (up to 15 percentage points).

Given the different ESG focuses and challenges of companies and respective industries, the nature of ESG metrics varies quite significantly. Globally, among the most common topics used are social criteria (72%) such as diversity & inclusion or employee engagement, environmental criteria (50%) such as GHG Emissions and renewable / non-renewable energy, and customer focused criteria (37%) such as customer satisfaction or product quality and safety. Especially the E-dimension has significantly increased compared to last year, indicating that companies are taking environmental responsibility.



4. ESG in LTI to anchor the sustainability strategy

While the integration of ESG in STI frameworks has almost become a «must» for modern compensation designs, the integration in long-term incentive plans (LTI) is still less common. Having said this, leaders are increasingly realizing that sustainability is a long-term commitment. To align with long-term strategic plans, more and more companies are therefore considering ways to reflect ESG performance in LTI plans. Currently, on a global scale 22% (2021: 16%) of companies do so with an average weighting of 26%. While in Switzerland only 10 SPI companies reflected ESG in their LTI plans during the 2021 cycle, the increase by 6 companies from previous year is significant.

For example, Holcim was one of the first Swiss listed companies to not only integrate ESG in their STI but also in their three-year performance share plan. Within their LTI, environmental criteria are weighted at 33%. Specifically, targets regarding CO2 emissions, the quantity of recycled waste, and freshwater withdrawal are included. All three are aligned with Holcim's sustainability strategy and its commitment to build a net-zero future by taking a rigorous science-driven approach, with its industry's first net-zero 2030 and 2050 targets, validated by the Science Based Targets initiative (SBTi).

In Europe, more companies have included ESG in their LTI programmes. For example, one third of the LTI grant at Deutsche Bank in 2021 was based on their ESG factor, comprising seven weighted metrics in the E (e.g. sustainable finance and investments), S (e.g. gender diversity) and G (e.g. anti-money laundering remediation) dimensions, making up for 20% of the total variable compensation of the executives.

Since the majority of ESG topics seem to be rather long-term ambitions that are not solved within the one-year cycle that STI plans typically have, it might seem surprising that companies are still hesitant to include such measures in their LTIs. However, companies are struggling with several challenges when aiming at considering such topics in long-term compensation.

Firstly, traditional LTI plans are typically driven by purely financial metrics such profit-related KPIs or TSR, while non-financial, strategic topics have historically been less considered – and less accepted by investors – in such plans. Secondly, many companies are still on a «learning journey» towards a more sustainable business model. This implies that ESG-related metrics might not yet be readily available and a robust internal or external measurement over a longer time horizon is often tricky – especially when the results thereof are ultimately linked to compensation outcomes which requires a high degree of tangibility and comprehensiveness. This also relates to the third challenge, namely the setting of relevant, long-term ambitions for ESG topics. While companies have decades of experience in setting relevant financial goals, in the non-financial area, target-setting is still difficult, especially in the current volatile market environment.

5. ESG in incentives: How to deal with trade-offs?

Including ESG in pay decisions can entail trade-offs because certain ESG and financial objectives are sometimes diametrically opposed – at least in the short term. For example, additional costs for a production plant with lower CO2 emissions reduce profits in the medium term. Also, trade-offs can exist within specific ESG initiatives, for example between building electricity consumption (E) and employee satisfaction (S), when thinking about the current energy saving initiatives. Such trade-offs require prioritization, aligned with the overall ESG strategy.

While several approaches exist to cope with such trade-offs, two alternatives come closest to solving the challenge.

1. Qualitative assessment: In this approach, ESG factors are incorporated into the compensation model in the form of an overall assessment. To this end, strategically relevant ESG topics are defined, which are underpinned by concrete criteria. These should be measurable but are not subject to a weighting and mathematical formula. Rather, an overall assessment of ESG performance is made by the Board. In Switzerland, listed companies are increasingly adopting this approach, as it reduces the pressure on the discussion about «true» performance and better accounts for trade-offs.

2. Framework conditions: Here, ESG criteria are defined as a minimum requirement or threshold. For example, a CO_2 reduction of x% or a safety improvement of y% per year would need to be fulfilled. This increases the robustness of the compensation model and shifts the discussion about trade-offs between ESG and financial performance to the strategic level – or rather to the periodic discussion about how ambitious these thresholds should be set.

Based on our experience, those two approaches can solve the questions around potential trade-offs most adequately. In addition, they allow for a comprehensive reflection of the perceived performance by investors, Board members and managers. With this, integrating ESG in compensation can help companies to address stakeholders' concerns, ensure credibility and improve reputation and ultimately make significant progress on their ESG strategies also in the long-term.