Sustainability in relation to variable compensation

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The concept of «Sustainability» is not new: the Swiss Federal Constitution of 1874 already covers sustainability in relation to agriculture and combines this with production that is market oriented. This concept has evolved over decades to cover Environmental, Social and Governance («ESG») topics. In the 1990s and early 2000s, those topics tended to be covered under the umbrella of «Corporate Social Responsibility», typically outside the core business. More recently, companies, investors, proxy advisors and regulators alike have recognised that topics commonly covered under ESG are essential to sustainable value creation for shareholders, employees and society. Employees, especially the younger generation, expect real progress towards a more sustainable future.

In view of this, it is becoming standard practice to integrate ESG aspects as part of core business operations. For an increasing number of companies, this also includes an integration in variable compensation schemes such as annual and/or multi-year bonuses.

This article discusses key practical aspects which Boards of Directors and their Compensation Committees may need to assess when considering the integration of ESG in variable compensation schemes. It also elaborates on how Swiss Re has integrated ESG in its variable compensation scheme.

1. The pros and cons of integrating ESG in variable compensation schemes

With ESG being so prominent on investors', proxy advisors' and the general public's agenda in recent years, integrating ESG in variable compensation may seem like an obvious move. Conceptually, however, one might argue that ESG is «the right thing to do», i.e. an absolute baseline of doing business similar to ethical conduct and compliance with applicable laws and regulations, which should not be rewarded separately.

Certain studies have suggested that companies that do well on ESG, show more sustainable long-term financial performance.[1]

1 See for example Tarmuji, Indarawati, Ruhanita Maelah, and Nor Habibah Tarmuji. «The impact of environmental, social and governance practices (ESG) on economic performance: Evidence from ESG score.» International Journal of Trade, Economics and Finance 7, no. 3 (2016): 67 or Giese, Guido, Linda-Eling Lee, Dimitris Melas, Zoltán Nagy, and Laura Nishikawa. «Foundations of ESG investing: How ESG affects equity valuation, risk, and performance.» The Journal of Portfolio Management 45, no. 5 (2019): 69-83.

If ESG drives sustainable long-term financial performance, rewarding for both ESG and financial performance could come close to 'double rewarding' for one and the same effort.

Finally, investors and proxy advisors agonise over companies' use of vague and poorly measurable qualitative ESG metrics, which make it difficult to assess whether there is real progress.

On the other hand, if ESG metrics are tangible, measurable and explainable, these can be a strong factor to substantiate a company's commitment to ESG, both internally and externally, and drive employee commitment and engagement.

2. Options for integrating variable compensation in the compensation framework

Companies deciding to integrate ESG metrics in variable compensation will face a number of practical considerations, namely i) which metric(s) to consider, ii) which weighting and upside/downside potential to use, and iii) – for companies that have more than one variable compensation scheme – which scheme to use (i.e. short- and/or long-term variable compensation scheme).

3. Metrics

Much has already been published on measuring progress on ESG and the most suitable measurement approach will depend heavily on a company's industry, business model and strategy. We therefore briefly touch upon the choice between internal and external metrics and provide some commonly used metrics.

We consider as internal metrics those designed and developed by the company internally, while external metrics are those used by third-party institutions, such as the Dow Jones Sustainability Index (DJSI) or MSCI Index (indices which independently evaluate the sustainability performance of companies in a consistent way so that their performance can be compared). Both present some key practical advantages and disadvantages, as shown in the table below:

	Internal metrics	External metrics
Advantages	▪ Tailorable to company's exact business model, operations and ESG challenges. ▪ Reporting can be aligned to the company's (financial or other) reporting timelines as needed or required by regulations.	▪ Element of credibility thanks to third-party validation. ▪ Comparability amongst participating companies. ▪ Public recognition/marketing of results.
Disadvantages	▪ Business confidentiality may hinder/prohibit external reporting, which, however, is critical to substantiate ESG commitments. ▪ Does not allow stakeholders to easily compare between companies.	▪ Depending on metric(s) chosen, significant internal resources can be required to complete the reporting to the third-party institution. ▪ Metrics may not be well tailored to a company's business model. ▪ Potential lack of available data for some of the data points requested by the third-party institution. ▪ Dependence on the third-party institution's (perceived) standing, (changing) method, number of participating companies and timeline to receive results.

To offset some of the challenges of using either internal or external metrics, companies may consider the use of a combination of both to leverage the third-party validation element of external metrics and the flexibility offered by internal metrics. In this context, it is important to keep the total number of metrics at a manageable level to avoid a potpourri of metrics diluting focus in the variable compensation scheme.

Examples of commonly used ESG metrics are as follows:

Environment	Social	Governance
Air quality/ pollution	Customer satisfaction	Audit strategy
Carbon emissions	Diversity and inclusion	Board capabilities
Climate change strategy	Employee education	Board independence
Energy usage	Employee engagement	Business ethics
Plastic usage	Equal pay	Compliance (with law & regulations)
Soil quality/ pollution	Health & safety	Risk management
Sustainable investment	Human rights	Sanctions/ legal settlements
Water usage/ pollution	Labour rights	Stakeholder engagement
Waste management	Value chain management	Tax strategy

The list of potential targets seems endless, and it may be difficult to prioritise e.g. carbon emissions over customer satisfaction, or labour rights over risk management. To define which metrics will make a difference to the company, a clear company strategy is key. After the metrics have been chosen, tangible and measurable target levels (eventually with a threshold and maximum) will need to be defined to show sufficient stretch to investors and proxy advisors.

4. Weighting and upside versus downside potential

With weighting, we mean the relative weight of ESG metrics in comparison to other (most commonly financial) metrics used in determining variable compensation outcomes. Market practice varies widely across companies and industries, which shows that there is no «one size fits all» approach. Though, we would argue that the more tangible, measurable and disclosable the chosen ESG metrics are, the higher the weighting can be, especially if the company publishes concrete targets and achievements. On the other hand, intangible, catch-all metrics along the lines of «Making [non-quantified] progress on...» risk being challenged by investors as a potential means to offset poor financial performance. That being said, for companies that are at the beginning of their ESG journey, there can still be value in using such metrics (with a relatively small weighting) to underline ESG commitments both internally and externally.

Another option to mitigate the risk of challenge by investors is the use of ESG metrics only for potential downside, but not for upside in the variable compensation scheme. With this, poor performance on ESG would have consequences by way of lower variable compensation payouts, while performance at or above expectations will not result in higher variable compensation payouts. On the flipside, the incentivising factor for employees and management to make extra efforts on ESG may be limited in this set-up.

5. Short-term versus long-term variable compensation schemes

Companies with more than one variable compensation element will most commonly have a short-term (typically an annual bonus, rewarding performance over one financial year) and a long-term variable compensation scheme (typically a cash- or share-based incentive, rewarding performance over a three- to five-year period and paid out at the end of that period).

The short-term variable compensation scheme generally touches a larger portion of the workforce. Due to the short line of sight, employees below senior management likely feel more committed as their behaviour directly contributes to achieving ESG targets. This may drive change faster. As an example, a metric to reduce CO2 emissions triggers employees to consider alternatives to business travel by plane.

The long-term variable compensation scheme may seem a more obvious choice considering the long-term nature of many ESG issues; after all, progress on issues such as human rights may not be visible in a one-year timeframe. Long-term variable compensation is oftentimes limited to the more senior employees in the workforce. As a result – and this can be intentional depending on the company's compensation philosophy – ESG metrics may not impact compensation for the majority of the workforce if the path of long-term variable compensation is chosen. However, even to senior management, the long line of sight may be perceived as less motivational, and progress may not be (directly) reflected in typical long-term performance indicators such as the company's share price.

Short-term variable compensation schemes allow for a higher degree of flexibility as the metrics and targets considered can be changed on an annual basis if needed. On the other hand, for the long-term variable compensation schemes, these metrics and targets are locked in for the three- to five-year performance period as so called «in-flight» changes to metrics and targets during that period tend to be perceived negatively by external stakeholders (the general presumption being that targets are changed to make them more easily achievable and hence to generate higher payouts at the end of the performance period).

Regardless of the option chosen, it is key for metrics to be tangible and – depending on the desired level of transparency – suitable for internal and external communication. Companies may therefore go through a number of maturity levels, starting with qualitative targets and moving to more quantifiable targets as their ESG strategy and measurement approach matures.

6. Assessment process

Assessment of achievements against ESG targets, especially when these are qualitative, can be difficult. Credibility of outcomes can especially be problematic when the performance on ESG is better than the financial results. Simple and clear measures as well as a robust assessment process agreed at the start of the year are essential. A specific body carrying out the assessment and eventually an independent audit of the results may be helpful to convince internal and external stakeholders.

7. Swiss Re

At Swiss Re, we consider «Sustainability» a strategic, long-term value driver. Our Sustainability approach is embedded throughout our re/insurance value chain: from the liability to the asset side of our balance sheet, our own operations and dialogue with our stakeholders.

As an example, climate clearly plays a role in natural catastrophe losses, over half of which were caused by secondary perils such as floods, drought, wildfires or winter storms. As our business is impacted by climate change, we play an important role in tackling it: we provide natural catastrophe re/insurance to help governments, corporates and individuals on the ground with reconstruction efforts in the wake of a natural disaster, we help combat climate change by providing risk transfer solutions that help mitigate the associated risks and advance the energy transition and we decarbonise our underwriting business. This contributes to environmental, social and economic sustainability.

But mitigating risks of climate change is not the only challenge for society: fighting inequities is another. Swiss Re focuses on improving access, affordability and availability of life and health insurance products to populations that have traditionally been underserved by our industry, such as women, immigrant communities, ethnic minorities and informal workers.

Swiss Re believes that lasting progress comes from striking the right balance between building upon past sustainability achievements and taking decisive action. To focus the workforce's energies on the topics that are deemed most important in a certain year, Swiss Re defines clear KPIs – tangible to the extent possible – for the Group as a whole and for each Business Unit and Group Function at the start of the year.

Our sustainability-related KPIs are aligned to Swiss Re's Group Sustainability Strategy and take into account our sustainability ambitions. Swiss Re uses a combination of external and internal metrics as disclosed in the Climate-related financial disclosure section of our Financial Report and in our Sustainability Report.

Select sustainability-related KPIs are linked to Swiss Re's short-term variable compensation scheme to focus on the right priorities in a certain year. At the end of each year, the Group, Business Units and Group Functions report on their performance, whereby Swiss Re's Sustainability Council reviews the outcome of specific group-wide sustainability-related KPIs. As a result, sustainability-related KPIs impact variable compensation for all employees, including members of the Group Executive Committee.

Examples of external metrics Swiss Re used in the 2021 short-term variable compensation scheme were the company's leading role on ESG as recognised externally by leading Sustainability indices as the DJSI and MSCI, but also Swiss Re's profile as an active voice in public discussions on sustainability and climate. As internal metrics Swiss Re focused on the share of sustainable business, reducing the carbon footprint of our operations, investments and insurance activities as well as topics like representation of women in leadership, customer focus (Net Promotor Score) and risk & control behaviour.

We continue monitoring developments on Sustainability/ESG and regularly review and adapt our approach in line with our business strategy.