GRG Remuneration Insight 163

ESG Remuneration Considerations

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Introduction

Introducing Environmental, Social and Governance (ESG) metrics into incentive remuneration plans is currently a topic with which many Boards are struggling. This Insight discusses many of the aspects of this topic that arise in Board considerations of ESG and seeks to answer questions such as which ESG metrics should you focus on, how do you measure them, and what weighting should you apply to each metric.

Nature of ESG Issues

The following table presents an example of the types of issues that fall under each category of ESG:

Environment	Social	Governance
Greenhouse emissions	Health & safety of employees	Ethical behaviour including corruption, anti-competitive behaviour
Pollution of air, water and soil	Child labour and modern slavery	Regulatory and certification compliance
Waste reduction and recycling of materials used by the company	Diversity of employee groups including gender pay equality	Board diversity
Sourcing recycled material to replace natural resources	Dealing fairly with customers	Executive remuneration
Degrading natural habitats and impacting biodiversity	Recognising the land holder and traditional owner rights	Documentation and communication of company policies

Clearly not all of these issues will have relevance to all companies and even where some are relevant, they may have different levels of importance to the company. Thus, the first step is to identify those ESG metrics that are relevant to your company and how important each issue is.

ESG Metrics and Measurement

Once the relevant issues have been identified the next step is to be specific about what aspect of the issue needs to be focussed upon in order to drive better performance in relation to that issue. As an example, we will use “health & safety of employees” as the issue. This is an entrenched metric in some sectors and “lost time injury frequency rate” is a commonly used metric. It is also common practice for management and insurance purposes for companies to keep detailed records of the number of days lost per year and by location. Of course, on-the-job deaths is another important aspect of this issue.

Ideally, ESG metrics should be measurable and, if sufficiently important, the company should have in place objective setting and measurement systems to set expectations and record performance.

Including ESG in Executive Remuneration

STI or LTI

ESG metrics may be incorporated into short term incentive (STI) and long term incentive (LTI) plans. The time period expectations associated with the particular metric will determine which plan is most appropriate. To illustrate, the previously raised example of "lost time injury days" can be measured over a period of one year and therefore it is often used in STI plans. On the other hand, an ESG metric related to sustainable carbon footprint reduction may take years to invest in and bring online processes that improve efficiency or bring green energy online. For environmental impact and remediation, it may take many years to reveal damage that may be directly attributed to a company and action remediation. Accordingly, such metrics seem most suitable for use as part of an LTI plan.

Metrics, Gate or Modifier

There are three main ways in which an ESG metric may be incorporated into incentive plans. They are:

Use	Comments
Metric	This is when a metric is included in the plan as a discrete item for measurement, with a specific award attached to achievement.
Gate	This is when a failure results in all awards being cancelled.
Modifier	This is when the metric is not part of the calculation of the initial award and there is no discrete award identified for the outcome, but it is applied to modify (increase or more often decrease) the award that would otherwise be payable.

Which of these is chosen would be influenced by the importance of ESG to the company and its stakeholders, as well the organisation's ability to forecast and measure the metric. For example:

- High importance and the metric is forecastable and measurable: then ESG may be used as a metric and given a relatively discrete weighting in the award calculation. The weighting is often modest unless it can be clearly linked to value for stakeholders.
- If good performance or avoidance of failure were seen as essential for the company's survival: use ESG as a gate so that poor performance leads to no incentive award payable under the plan.
- Limited capability to precisely forecast and measure but wanted to use a subjective assessment to turn off awards when expectations were not met: use ESG as a gate.
- ESG is important and the board wants to reinforce that message to incentive plan participants: use ESG as a down-side modifier (where ESG management is mainly a risk management activity), or (if linked to value for stakeholders), use also as an up-side modifier, which would allow changes in performance to be strongly fed back to participants via the modification of their incentive awards.

Deferral Modifier

Another variation in the use of ESG as a modifier is to require a portion of incentive awards to be deferred for a period. Then at the end of the deferral period measure performance in relation to the ESG metric or scorecard. Then based on that assessment the deferred award could be modified by reduction or increase. This approach is often used by large institutions in the financial services sector where it is legally required for 40% of awards to be deferred for at least 4 years, although the modifier only acts to scale down the award, not to scale it up.

This could be a good approach for ESG metrics where change occurs over periods that exceed the typical measurement period for short term awards, but cannot be integrated into the typical long term incentive structures, or where measurement may exceed the typical period of 3 years for LTI plans.

Performance Scales

While it is possible to leave the assessment of performance in relation to ESG to Board discretion, this approach has not been seen as the most effective approach for other incentive metrics. For most metrics the preferred approach is to use a scale with a range typically from threshold at the low end, to target being planned or expected performance, and up to stretch which is seen as outstanding performance. These scales are typically communicated to participants at the beginning of the measurement period, so they know the range of expected outcomes and what they need to achieve to earn various levels of incentive award. At the end of the measurement period actual performance is compared to the scale and earned awards are calculated. In order for metrics with discrete awards attached to them to be acceptable to many external stakeholders, they need to be measurable, forecastable, reportable and linked to stakeholder value. For many organisations, the ESG strategies, plans, tracking and reporting systems necessary to deliver on this expectation, have not been developed yet.

ESG Scorecard

For most companies there will be several ESG metrics that should be included in an incentive plan. So as to cover all of these metrics without overloading the incentive plan it can be useful to combine them into an ESG scorecard. The scorecard will cover all relevant ESG metrics, weight them to reflect their relative importance and cover the range of potential outcomes. The outcome of the scorecard could then be used as a separate performance metric in the incentive plan or as a gate or modifier or deferred modifier. This can also assist where assessments are currently not supported by formal forecasting, tracking and reporting, and Board discretion needs to apply to determine the quality of the performance, such as is often the case with individual performance assessments.

Taking the First Step

If a company is in the early stages of introducing ESG into its incentive remuneration plans, GRG can partner with you and assist by:

a) reviewing the company’s circumstances,
b) agreeing with the Board and management:
    i. which are the issues that are most relevant to the company,
    ii. which are the ESG metrics that need to be considered for each issue,
c) confirming which measurement systems are currently available for each metric,
d) undertaking a gap analysis between the measurement systems that are required and those that are available,
e) develop a strategy for closing the gap and/or transition strategies to cover the period during which detailed measurement systems can be implemented.

Please call James Bourchier or Peter Godfrey on (02) 8923 5700 for further information and assistance.