Linking ESG to Remuneration

Author: James Bourchier

Introduction

One of the hottest topics across stakeholder groups for ASX listed companies in 2024 is ESG ("environmental, social and governance"), which is getting a lot of attention in board rooms, annual general meetings and remuneration committee meetings. In this article, we explore why this is the case, if and how ESG should be linked to remuneration, alongside some of our observations regarding emerging market practices. We also provide an example of how an ESG, or risk scorecard can be used as a gate, modifier, or as its own discretely weighted metric among more traditional metrics.

Why is ESG a hot topic?

The reasons why ESG is a current hot topic will vary depending on who you talk to. However, the most significant reasons cited are outlined below:

1. **Customer and community demands:**
    a) The activities of companies in pursuing profit have never been so visible.
    b) Governments and voters are more engaged than ever with issues of sustainability, ethics, and fairness across the economy.
    c) Companies that breach social expectations often face quantifiable financial loss, community, customer and/or government action, and other repercussions.
2. **Modern strategy includes it:**
    a) Strategic thinkers recognise that managing business risk cannot be limited to financial considerations, but also the sustainability of environmental impacts and social impacts.
    b) Managing non-financial risk and value can add to or protect financial value.
    c) Competitive advantages can be obtained by better managing non-financial value.
3. **Shareholders and proxy advisors bring focus to it:**
    a) The fastest growing investment portfolios are based on "ethical", "climate friendly" and "ESG" investments. These have often outperformed more traditional portfolios in recent years.
    b) Large institutional investors are increasingly setting out the ESG standards they expect companies that they own significant portions of to adhere to, or risk major selling down of their stock.
    c) Every proxy advisor report includes an ESG assessment.
4. **Regulators are forcing the issue:**
    a) Australian Sustainability Reporting Standards: the first tranche of regulated sustainability reporting requirements (climate-related disclosures) derived from the ISSB/IFRS will soon apply to Australian company disclosures. This will require discussion of links between KMP remuneration and climate-related risk.
    b) APRA: CPS/CPG 511 require financial entities to explicitly manage, and link reward to non-financial risk management and sustainability.
    c) ASX Listing Rules: the ASX Corporate Governance Council's Principles and Recommendations have long required listed companies to consider climate, sustainability, and non-financial risk.

Market Trends

Looking across our database of 1,200 ASX listed companies, we are able to make some observations about the types of ESG metrics used, and how they are used, as part of short term variable remuneration (short term incentive, STIP or STVR) or long term variable remuneration (long term incentive, LTIP or LTVR). GRG is currently updating its Variable Remuneration Guide publication, and we will offer another Insight with the latest market data summaries on ESG metrics as part of the launch. In the meantime, here are some observations we have made from our previous work in this area:

1. ESG metrics are significantly more common in STVR structures than in LTVR structures. STVR metrics tend to be subject to lesser scrutiny and rigidity, covering a wider range of types of outcomes, while LTVR tends to be focused, highly scrutinised, and subjected to more rigid views regarding acceptable approaches.
2. Many of these "ESG" factors are not new and would previously have been considered "soft metrics", HR management, hygiene factors, or part of a balanced scorecard. Metrics like employee culture/values and customer satisfaction have been popular candidates for executive STVR for many years, often poorly regarded or rejected, but appear to be being rebranded as "ESG" in some cases (engagement falls into this bucket also but was excluded from this research). Similarly, safety has long been a controversial metric, with many arguing that it should not be the subject of additional reward, and should instead be a minimum gate, but is appearing again in the guise of ESG, alongside the avoidance of environmental and regulatory breaches. These types of metrics are arguably not true ESG metrics, as they tend to relate to failures in management (or the avoidance of such) rather than being indicators of success or value creation in the environmental or social domains.
3. Overall, across all sectors, climate/carbon reduction objectives appear to be the strongest represented variable remuneration metrics in the ESG space, likely because they are clear, quantifiable objectives that are relatively easy to track and are readily accepted as both necessary and adding value to the environment and to society.
4. Beyond this, the two other commonly observed metric classes are:
    a) environmental compliance and safety, which are arguably minimum operating requirements for the types of companies that typically use them e.g. resources companies, and
    b) diversity, again likely because it is quantifiable and forecastable.
5. There are surprisingly few companies linking KMP remuneration directly to sustainability reporting and outcomes therein, despite the rapid increase in companies undertaking sustainability reporting. Even fewer companies are linking remuneration to reports based on compliant/standardised reporting, with assurance (such as the Global Reporting Initiative based reports).

Many attempts at including non-financial metrics in executive reward have faced significant push-back over the years, and ESG metrics have similarly faced mixed support, consistent with this history. However, responses to attempts to include these types of metrics vary significantly by industry, and by the specific kind of metric being introduced.

It should be noted that regulators, including ASIC, are also now putting pressure on companies to ensure that green, ESG and sustainability claims are genuine, and not used to mislead shareholders, customers or the community.

GRG's Advice (for most)

Linking ESG to remuneration is clearly on the agenda for many stakeholders and is not going away. GRG advocates the use of ESG and non-financial value/risk metrics when:

a) the company has a significant environmental and/or social impact that needs to be managed, and/or
b) the company takes ESG matters seriously and genuinely integrates this thinking into its strategy, or
c) it is required by regulators.

GRG's advice is that the best way to link remuneration to ESG, sustainability and non-financial risk metrics is to engage in sustainability reporting; this requires the development of systems and processes to map, track, forecast and report on environmental and social outcomes. When well-recognised sustainability reporting standards (e.g. Global Reporting Initiative or GRI) are adhered to and are the subject of "assurance" (the ESG equivalent of audit), the usual requirements for linking performance outcomes to remuneration will be met - objectives can be clearly articulated, measured, forecasted, and linked to both the company strategy and to financial risk/value outcomes.

Where ESG reporting and strategy identify areas of clear opportunity for value creation (triple bottom line value creation, not just financial value creation) then associated measures will be good candidates as performance metrics driving executive reward, and meeting market expectations regarding rigour.

However, where the approach to ESG management, strategy and reporting is less developed, and one or two clear value-driving metrics do not stand out in the strategy, the best approach will be to develop an "ESG scorecard" or "risk scorecard" similar to "balanced scorecards" used for general staff bonuses but limited to ESG and risk factors. Then either:

a) use the outcome of the ESG scorecard as a discrete metric, weighted among other more traditional metrics, noting that this may be viewed by some stakeholders as effectively discretionary, if not linked to transparent reporting on scorecard metrics or an assured sustainability report, or
b) use the outcome of the ESG scorecard as a gate or modifier, turning off or scaling the rewards flowing from the outcomes of other, accepted metrics.

Both of these approaches should face lesser criticism than trying to include many discrete, weighted metrics related to ESG that may be considered "wishy washy", by offering only minor up-side in pay.

Due to the requirements of the Banking Executive Accountability Regime, the Financial Accountability Regime, CPS 511 and CPG 511, specialised approaches need to be taken when linking remuneration to non-financial risk and ESG in the financial sector.

ESG (or Risk) Scorecard Example

The following provides an example of an ESG scorecard:

ESG Scorecard (Example Only)		
Metric	**Score out of 10**	**Weighting**
Environmental		
Carbon footprint (excluding energy)		**10%**
Green energy percentage		**10%**
New plastics volume reduction		**10%**
Social		
Customer wellbeing impact		**10%**
Net social impact assessment		**10%**
Diversity and gender pay equality remediation		**10%**
Governance		
ESG reporting systems development plan		**10%**
Personally Identifiable Information protection		**10%**
Ethical supply chain improvement		**10%**
Global Reporting Initiative Report results improvement		**10%**
Total		**100%**

The score from this scorecard could be used as a discrete metric with its own weighting in an STVR program. For example, a Threshold score of 65% could be associated with a reward of $10,000, a Target score of 85%, $20,000, and a Stretch score of 95% or more, with $40,000, with pro-rata outcomes in-

between. Alternatively, the result of the score card could be used as a gate, for example turning off the opportunity for all other metrics if the scorecard result was less than 65%, or as a modifier, using a scorecard result scale such as follows:

ESG Scorecard Score	Modifier
>90%	0%
90%	0%
Pro-rata	Pro-rata
65%	-100%
<65%	-100%

The foregoing similarly "turns off" all awards for a score of 65% or less but has a more nuanced effect on the award for outcomes above this, up to an acceptable level.

Conclusion

Links between KMP remuneration and ESG are likely to be the focus of stakeholder interest in the remuneration space for years to come. While strong trends in using metrics that are well accepted, and genuinely drive value creation in the ESG space are still emerging, action is needed to start on the journey. There are clear pathways forward that any company can consider, that recognise the expectations of multiple stakeholders, bearing in mind the systems and processes needed to provide the precision that some demand may take some years to develop. It is also clearer than ever that to address these matters properly requires serious investment in analysis and reporting.

GRG's consultants can assist any company in starting on the ESG journey in relation to linking relevant metrics to remuneration outcomes for their executives. This can include how to incorporate ESG into variable remuneration plans, to designing an ESG scorecard as a modifier, tailoring a solution to suit your business and stakeholder expectations. Our team can also assist with designing and building ESG reporting and planning systems and help start the journey on integrating ESG and sustainability into your business strategy.

GODFREY REMUNERATION GROUP PTY LIMITED
ABN 38 096 171 247 | WWW.GRG.CONSULTING
LEVEL 7, 75 MILLER STREET, NORTH SYDNEY 2060 TEL (02) 8923 5700

ENQUIRIES: info@grg.consulting

GODFREY REMUNERATION GROUP