NFP

Compensation Consulting

compconsulting@nfp.com

281.378.1350

NFPCOMPENSATION CONSULTANTS.COM

ESG & Executive Compensation: A Deeper Look Inside the Growing Trend

KEY TAKEAWAY

ESG as metrics in incentive programs must be carefully considered. The lesson is to be aware of external desires, but make decisions based on incentivizing actions that support shareholder growth and maintain the integrity of executive incentive plans.

Effective compensation programs have a strong circular relationship between measurable goals, tangible performance, and actual payouts. This is true whether the goal or goals are short-term or long-term in nature. But what happens when the lines between goals and performance become blurred? Do the compensation programs themselves cease to carry the same power to influence actions? Or even more concerning, are the actions being influenced in the best interest of stakeholders?

The purpose of business has long been simplistic. Generate returns for all stakeholders and take actions that establish a strong foundation for continued performance over a long period. Influencing executives to attain these goals was achieved through identifying metrics that were complementary to the overall business purpose. For the most part, these same metrics are the foundation of most executive incentive programs today. Focusing on revenue growth, earnings, expense management, returns on investments, and leverage has served strong companies and their stakeholders well and rewarded executives where execution was achieved.

In the business realm, these terms are commonplace. No one questions whether their achievement is relevant since, without their achievement, a company's demise is imminent. The problem is, gone are the days of simplicity.

Never in the history of business have companies had to juggle so many outspoken parties, each now expressing opinions regarding how businesses should be run and compensation programs structured. This has complicated matters immensely, as Boards, executives, and consultants must now work together to triangulate the best incentive plan course while staying true to their strategy and avoiding sounding tone-deaf to the various constituents.

Blurring the Lines

The use of qualitative goals, or even discretion, is a healthy addition to an executive incentive plan. Strategic goals allow companies to incentivize management to achieve certain objectives which are necessary for establishing a strong, long-term foundation. Many times, while these goals are not quantifiable in the mathematical sense, they are nonetheless crucial.

Within the S&P 500, greater than half of companies use one or more strategic metrics. These metrics are secondary to quantifiable financial and operational metrics, and on average make up less than 20% of the overall bonus potential. Still, their inclusion at such a prevalent rate indicates their importance.

However, a deeper review of these strategic metrics, over a period of time, indicates a sea change. Over the past two years, the variance of strategic metrics among these companies is changing. Strategic metrics were historically widely varied, with few companies using the same metrics. This is easy to understand…strategic metrics by their very definition are specific to a company and what they are trying to achieve. This is becoming less the case and its implications may prove harmful long-term.

No one can deny the importance of making decisions that are beneficial to the environment, increase workplace safety, improve overall social equality, and alter company governance for the better. Metrics that fall under these categories are termed ESG metrics and are the new metric darling of institutional investors.

Prior to 2019, less than 20% of S&P 500 companies had an ESG metric in their incentive program. In 2021, the paradigm has shifted. Now, 57% of S&P 500 companies use at least one ESG metric, and the number using the same or similar metrics is on the rise. The cause…external pressures for inclusion from shareholders, environmental and rights advocates, and the government.

Again, the purpose of these objectives is important and noble. We should, as well-meaning businesses, endeavor to do our very best to protect the environment and promote equality. The question is, should all companies be pressured into including one or more of these metrics in their incentive programs, thereby potentially diluting the impact on the very goals which allow these companies the latitude to possibly address these issues more effectively?

An ESG Snapshot

There remain varied perspectives on the validity and relevance of the types of ESG metrics that should be included or can be included in incentive programs. This is not surprising given the gambit of alternatives available. However, while common themes are emerging in regards to the type of metrics and the means in which they are measured, more concerning are the seemingly over-granular and marginally impactful goals being included just for the sake of claiming ESG usage.

Diversity and Inclusion metrics, such as the percentage of women on the Board or minorities in management positions, are among the most prevalent metrics in the broader industry, while environmental and safety metrics (carbon emissions, safety) dominate the energy sector. No question, these are each important to the continued growth of a company. Also, while small variances in the measurement of effectiveness exist within these broader themes, the over-arching goals are similar enough to provide a means by which to compare results and identify best practices.

Conversely, there seems to be a growing theme of utilizing seemingly marginally impactful goals in the name of claiming to use ESG metrics. While the evidence of this is not incontrovertible, it becomes clear that thoughtful ESG metric selection needs to trump unmitigated ESG usage.

The measurement of ESG metrics varies, with the majority of companies choosing to provide less specificity in the goal targets, as well as mechanics of the programs. In fact, only 8% of S&P 500 companies provided specific details around either of these points. This highlights either the uncertainty of goal setting or possibly the perspective of attempting to assess overall ESG achievement, without being overly granular. Both present their own set of drawbacks that have a direct correlation to the perception of mismanagement of associated incentive payouts.

To ESG or Not to ESG…That is the Question

In a 2022 publication titled "The Perils and Questionable Promise of ESG-Based Compensation", authors Lucian Bebchuk and Roberto Tallarita, explore whether the explosion of ESG metrics into the compensation scene is beneficial or harmful to the effective design of executive compensation programs. They present two findings, both of which should interest Compensation Committees and management alike.

First, it is the job of executives to serve all shareholders, not subsets. Many ESG metrics are overly-focused on subsets of stakeholders. For example, most diversity metrics are aligned toward a gender or minority-specific cause. This inherently shifts the focus of executives to the execution of programs that serve a limited population, not the company as a whole.

While the importance of diversity and inclusion cannot be understated, it is arguably better addressed outside of compensation programs. This allows companies to focus on the development of these programs, without being unduly influenced to make decisions that are not appropriate for the company but result in a larger bonus.

Second, they argue that effective incentives should serve the stakeholders, not the interests of executives and that stakeholders should be able to scrutinize the link between executive compensation and goal achievement. This is true, as incentive programs should influence actions that ultimately improve the investment of stakeholders, while rewarding executives for execution. ESG metrics, as is being proven in the S&P 500, generally lack this linkage. The perception then becomes one of unjustifiably enriching executives for soft goals that are easily manipulated.

Bebchuk and Tallarita's conclusion is that ESG does not directly serve the stakeholders and that its continued expansion is not in the best interest of shareholders.

Conclusion

A focus on ESG has created significant improvements in many aspects of business. It has created a cultural shift and promoted a cohesive effort around ensuring environmental and social responsibilities are heralded alongside profits. However, ESG as metrics in incentive programs must be carefully considered. If the metric(s) are necessary to incentivize actions that marry to the long-term strategy of a company, they are relevant and should be included.

However, the inclusion of these metrics as a means of placating external parties is only succumbing to pressure and diluting the effectiveness of an incentive program. The lesson, as we've seen over the past few years, is to be aware of external desires, but make decisions based on incentivizing actions that support shareholder growth. The integrity of executive incentive plans must be maintained.