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ESG and Shareholder Value: Why Link Environmental, Social, Governance (ESG) Metrics to Executive Compensation?

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The NB Sustainable Equity strategy has long focused on material ESG issues. Over the past several years, we have seen company ESG initiatives become more sophisticated with companies providing more and better data and publishing targets and commitments to improve metrics and drive accountability. More companies are disclosing in accordance with the Sustainability Accounting Standards Board (SASB) and addressing the material issues outlined for their sector. In addition, the Securities and Exchange Commission (SEC) recently announced launching an Enforcement Task Force focused on climate and ESG issues thus reinforcing the notion that ESG issues are material for companies and investors.[1]

In our view, there is increasing evidence in the academic literature that sustainability has a positive impact on a company's earnings and increases shareholder value. In a well-run Sustainability focused organization financial goals and ESG goals are often in alignment. The boards of directors of High Sustainability companies are more likely to be formally responsible for sustainability and top executive compensation incentives are more likely to be a function of sustainability metrics.[2]

With mounting evidence pointing to the materiality of ESG issues and potential ties to financial performance, we have seen investors asking for more companies to incorporate relevant and material sustainability / ESG metrics into their executive compensation plans. A total of 89% of institutional investors in a 2019 survey agreed the inclusion of ESG and sustainability performance metrics and targets in executive long-term incentive plans is either "very important" or "somewhat important".[3] Linking an ESG metric to executive compensation in its early stages began with companies that have safety inherent in their business model, such as companies whose business requires a focus on employee safety to increase the productivity of the business, and thus these companies have a several year head start. Today, 45% of FTSE 100 companies have some form of ESG linkage in executive pay.[4] The focus and momentum over the past several years has been to encourage companies to examine and implement a meaningful ESG metric linked to executive compensation.

Laying the foundation for incorporating ESG into compensation

Companies with strong sustainability programs tied to business strategy, with targets in place as well as strong governance and oversight, can begin to discuss internally how the compensation structure can be inclusive of a short term or long term ESG metric. This is a logical next step for companies that have a high degree of intentionality and have truly made sustainability a part of their DNA. For those companies that have reached this stage where they can add a meaningful ESG metric to their executive compensation plan, we encourage them to proactively incorporate meaningful and relevant ESG metric(s) into their plan.

Below are some indications that suggest to us a company is well positioned to incorporate ESG into its executive compensation plan.

- Board level oversight
- Internal/External KPIs
- Programs and initiatives to address ESG challenges
- Targets in place to address the targeted issues
- Achieve third party verification and/or multi-stakeholder involvement
- Monitor and track progress
- Communicate to stakeholders

[1] https://www.sec.gov/news/press-release/2021-42
[2] High Sustainability companies are more likely to have established processes for stakeholder engagement, to be more long-term oriented, and to exhibit higher measurement and disclosure of nonfinancial information.
[3] Institutional Investor Survey 2019 – Morrow Sodali – 46Global Institutional Investors managing $33 trillion in assets under management
[4] PWC https://www.pwc.co.uk/services/human-resource-services/insights/environmental-social-governance-exec-pay-report.html

Linking ESG to executive compensation: recommendations for best practice

Once companies have laid the foundation for incorporating ESG into compensation, they can begin internal discussions with their board and compensation committee about how best to incorporate ESG metrics effectively into the incentive compensation plan. With that said, we believe the following considerations are important to the design of the plan.

- Companies should consider one or two metrics that are material and relevant to their business and attempt to identify quantitative metrics that are verifiable.
- In some cases, companies who would like to include more than one metric could implement a scorecard that captures a more comprehensive set of quantifiable metrics across topics.
- Just like any other compensation metric, the metrics should be created with realistic expectations and not be too aggressive or too easily achievable.
- Ideally ESG targets:
    - Should be a meaningful portion of executive compensation and reflected in the long-term compensation given the multi-period nature of most sustainability and ESG goals.
    - Align with the business/financial goals of the organization such as safety for a railroad or the use of a certain percent of recycled material in packaging for a consumer products company.
- ESG is an important aspect of a company's strategy and ESG metrics should evolve over time as the priorities of the organization evolve.

As ESG issues become an increasingly important component of a company's business strategy, we believe linking ESG metrics to executive compensation helps focus management's attention and incentivizes a more sustainable company that helps to drive additional shareholder value creation.