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A Framework for Tying ESG Metrics to Executive Compensation Plans

As the importance of ESG metrics continues to rise, what key factors should companies consider before incorporating them into their executive compensation programs? This article highlights useful steps to take to ensure your business is prepared to evolve pay design.

Investors are looking beyond traditional measures of profit and growth, utilizing environmental, social and governance (ESG) performance measures to differentiate companies as alternative investments. The list of ESG areas of focus has grown to now include sustainability, climate impact, human capital management and corporate governance. Investors expect companies to identify key ESG areas of focus, as well as disclose current statuses, goals for improvement and overall progress.

Investors are looking for increased accountability and transparency from the board and C-suite regarding ESG risks and strategies for improvement. We have seen companies focus on enhancing disclosure and engagement, which is the first step in improving accountability and transparency. Many firms are also looking to further demonstrate accountability through linking a portion of executive compensation to ESG goals. In order to create meaningful incentives with line-of-sight for executives, it is important for businesses to carefully assess their readiness for making this connection in incentive programs. From the investor perspective, is the incentive enhancing accountability and transparency? From the executive perspective, does the ESG incentive design motivate the right behaviors?

Before jumping straight to designing ESG incentives, we recommend assessing your company's readiness in terms of:

- Defining specific ESG metrics tied to long-term value creation
- Setting measurable goals
- Mapping out processes and milestones to achieve goals
- Establishing ability to track and measure progress for leadership to use in the decision-making process
- Evaluating ability (or willingness) to disclose information needed for transparency and accountability
- Understanding unintended consequences and potential risks of ESG metrics

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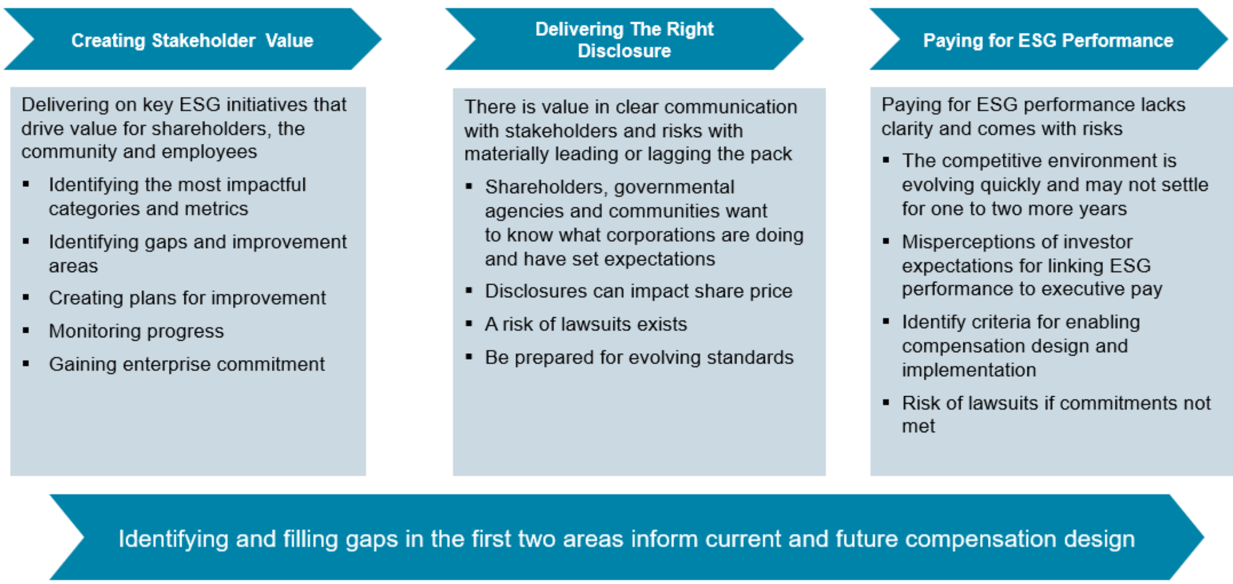
Framework for Integrating ESG Goals

There are two critical components to evaluating preparedness — value creation and disclosure. As with all solid executive compensation design plans, paying for ESG performance begins with understanding how your company creates value, and in this case, evaluating how ESG contributes to longer-term stakeholder value. As previously mentioned, disclosure drives accountability and transparency.

Figure 1

A Framework for Integrating ESG Goals into Executive Compensation Plans



Source: Aon's ESG in Executive Compensation Framework

When developed thoughtfully, linking ESG goals to executive compensation can help drive long-term stakeholder value. As a starting point, Aon recommends:

- Identifying ESG metrics that create the greatest value, align to company strategy and are most important to stakeholders
- Assessing the degree of transparency and accountability that exists through disclosure
- Establishing a compensation design and implementation timeline informed by the first two

Many of the answers to questions around metric selection are likely to start with existing sustainability and human capital management reports. However, more work may be needed to select the best incentive metrics. Not all value-creating metrics will be ready or appropriate for a compensation program in terms of setting a range of interim or long-term goals. Companies working through the "creating value" phase of their ESG journey need to assess what incentive design choices are available and whether incentive design will add to investor expectations for accountability and transparency.

To determine which metrics will be most effective for your company, consider the following:

- Importance to investors and other stakeholders
- Clarity of accountability at the board and senior leader levels; the ESG measures and processes may be sponsored by different board committees and/or senior leaders, but ultimately owned by all
- Commitment of the board and senior leaders
- Ability to systematically track progress and make course corrections
- Expected timeframe for achieving goals; i.e., achievability within the one- and three-year timeframes of most executive incentive plans
- Messaging and perceptions of metrics included and excluded in compensation plans
- Current and anticipated ability to establish quantifiable goals
- Risks to reputation or litigation if goals are not achieved

Assess the Right Time to Add ESG Metrics

Compensation committees currently determining when and how to design ESG-based incentives will need to focus more on impact and readiness of potential metrics and rely less on competitive practice compared to other areas of the executive compensation structure. As the use of ESG metrics in compensation plans evolves, we expect this aspect of incentive design to take two to three years before there are truly competitive norms and a strong understanding of investor and investor advisor standards. For now, the decision on when to implement should be based on degree of readiness, the nature of the ESG metrics, and the size and time frame needed to cover the performance gap.

Figure 2

What Is Your Stage of Readiness?

Exploring Changes:	Ready to Make Changes Now:
▪ Broadly defined metrics have been identified and disclosed for some categories of measures. Aspirational goals have been set ▪ Additional metrics are being explored but have not been defined or goals/timeframes not been developed ▪ Relative importance/priorities not yet set ▪ Internal teams to work on metric definitions and goals are still in process ▪ Key milestones and timeframes to achieve goals are not yet mapped ▪ Systems for assessing progress and reporting not yet established	▪ Several key metrics have been identified and disclosed for more than a year. Quantitative understanding of success or failure known ▪ Metrics have a range of performance associated with them and clear timeframes ▪ Additional metrics have been explored and either added or eliminated from consideration ▪ Relative importance/priorities established ▪ Internal teams working on metric definitions and goals have initial findings and an on-going agenda ▪ Key milestones and timeframes to achieve goals are mapped for all multi-year goals

▪ No back or future testing completed ▪ No assessment of risk	▪ Systems for assessing progress and reporting to leadership and the board have been tested ▪ Back or future testing completed ▪ Risk assessments completed and communicated to the board

Most companies fall somewhere between the two ends of the continuum. Once your firm has reviewed the disclosure and determined your readiness to select and set goals for ESG metrics, it is ready to align incentive plan design. If your company is still exploring, the design will likely have a shorter-term focus with participation limited to top executives. If your company is more ready, the design focus may be longer and include full leadership participation. Plan design features at each end of the continuum are described below.

Figure 3

Differentiating Plan Designs for Stage of Readiness

Exploring Changes:	Ready to Make Changes Now:
▪ Short-term incentive plans, focused on processes supporting longer term goals ▪ A single metric; the one most developed even if not the most important ▪ Qualitative, with award determination at the judgment of the compensation committee ▪ A small percentage of the incentive, e.g.,10% ▪ Limited to the CEO or all NEOs, as a communication	▪ In the long-term plan, since performance improvement on most ESG metrics will be a multiple year journey ▪ Multiple metrics (2-3) or a scorecard, focusing on the most important ESG metrics ▪ Quantitative measurement, likely with a range of outcomes linked to a range of pay opportunities ▪ A moderate percentage of total incentive, e.g. 15%-20% ▪ All leaders impacting performance of the metrics would participate

The incentive design choices to consider, given your company's degree of readiness and metrics, will include selections from the following key design elements:

- Long-term vs. short-term incentives (in some cases, both)
- Select metrics vs. scorecard
- Quantitative vs. qualitative measures
- Quantum; percent of total incentives
- Eligibility; how deep ESG incentives should go
- Level of board discretion (upwards and downwards) utilized when determining payout

How Disclosure Impacts Compensation Design

As a part of assessing your company's readiness, a determination of how potential metrics and goals will impact the disclosure is required. To ensure impact, a proper link of ESG to compensation will ensure a high degree of transparency and accountability that the disclosure alone can't provide.

Like any non-financial goal used in an incentive program, investors will generally expect transparent information around the determination of the company's level of ESG goals success at the end of the performance period. Additionally, there will be a heightened expectation for businesses to provide ongoing reporting for the ESG metrics used within their incentive programs, whether in a separate ESG report or within SEC disclosures. For instance, companies using diversity related metrics will likely be expected to provide ongoing diversity statistics and practices in ESG disclosures throughout the performance period.

Companies should consider the additional disclosure required and whether this level of supplementary information is consistent with the messages they want to send to stakeholders. In addition, the risk of falling short of disclosed ESG goals should be assessed.

So, while a company may be ready to establish goals and measure performance against ESG metrics, if not fully prepared for related disclosures, taking an "exploring" approach may be the best option for the near future. In these cases, a reasonable solution may be to delay tying ESG metrics to executive compensation for at least another year. Most large institutional investors have signaled an understanding of the challenges in linking ESG metrics to compensation and, in the immediate term, are more interested in what companies are doing and their communications through public disclosers. Delaying implementation and getting closer to being "ready now" is a viable choice.

Next Steps

With the focus on ESG remaining at the forefront, we know some companies are ready to integrate ESG into incentive design now, while others may need more time to assess how to do it right. Grounding decisions in what is best for your company based on your level of readiness and potential impact will be the most effective barometer for success. Thoughtful analysis and discussion are needed to ensure efficiency and mitigate unforeseen consequences of rushing to implementation.

Market practice for integrating ESG measures into executive incentives is quickly evolving. Aon will be continuing to monitor new or changed ESG incentive designs, as well as how investors and other stakeholders react to incentives that are:

- Based on soft metrics or opaque goals,
- Small relative to total compensation, or
- Based largely on compensation committee discretion.

Aon will next share how different plan designs support different metrics and states of readiness. For now, you can learn more about how Aon works with firms on their ESG strategies, including corporate disclosure and executive compensation design, at our future-ready boardroom hub.

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