THE ROLE OF ESG METRICS IN EXECUTIVE COMPENSATION

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The focus on ESG (Environmental, Social, and Governance) in corporate Canada continues to build. Boards and management teams increasingly review strategy and risk through an ESG lens, and shareholders and stakeholders expect companies to demonstrate measurable progress against their ESG objectives.

In this first article of our ESG series, we provide our perspective on ***why ESG metrics should be included in executive compensation incentive design.*** *Future articles in this series will provide practical considerations for doing so.*

Incentive Plans Should Measure What's Important…

It is a fundamental principle of executive compensation design that incentive plans should support an organization's strategic priorities. It follows that incorporating ESG metrics in compensation programs can support progress on strategic ESG initiatives and signal its importance to stakeholders.

The most common reasons companies include ESG metrics in incentive plans include[1]:

- Signalling that ESG is a priority,
- Responding to stakeholder expectations,
- Achieving ESG commitments, and
- Keeping pace with peers.

Incentive plans can also serve as a tool to ensure management focuses on priorities that may not directly drive financial results in the short term. This is particularly evident for environmental-based metrics (e.g., carbon emissions reduction), for which material outcomes are often realized outside of the typical shorter-term incentive performance cycles. Linking ESG objectives to executive compensation can bring focus on longer-term objectives and drive interim performance.

… and Measuring What's Important Drives Outcomes

Thoughtful incentive design (along with appropriate target setting) can support companies in driving performance outcomes. This perspective is well established among more traditional financial and operational performance metrics.

While the prevalence of ESG metrics in executive compensation is a more recent development in incentive design, early studies have found that the practice has been successful in driving ESG outcomes, including social and environmental initiatives, reduction in emissions, increased "green" innovation, and increased focus on important stakeholders.[2]

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[1] ESG Performance Metrics In Incentive Plans Roundtable, The Conference Board, 2022.

[2] Flammer, C, Hong, B, Minor, D. Corporate governance and the rise of integrating corporate social responsibility criteria in executive compensation: Effectiveness and implications for firm outcomes. *Strat. Mgmt. J.* 2019; 40: 1097– 1122.

Benefits of Driving ESG Outcomes

Driving ESG performance can support additional important priorities, a selection of which are summarized below.

ESG & Financial Performance	ESG & Risk Management	ESG & Cost of Capital	Investor Expectations	Stakeholder Responsibilities
Studies have demonstrated a link between ESG and financial performance, particularly over a longer-term time horizon.[3]	Focus on ESG matters can help mitigate environmental, social, or governance-related incidents in the shorter term, and help companies proactively manage systemic risks such as climate change in the longer term.	Research by MSCI found that companies with higher ESG ratings had a lower average cost of capital than those with lower ESG ratings.	Prominent institutional investors have expressed a view that companies should (at minimum) have a strategy in place that addresses ESG risks and opportunities. Several of these institutional investors have indicated a preference for incorporating ESG metrics into executive compensation.	The notion that that companies should create value for all stakeholders, not just shareholders, has become more and more mainstream, notably articulated by the Business Roundtable in 2019.

Looking Forward

Developing and executing against an ESG strategy has become a strategic priority for all organizations. In light of this, Boards and HR Committees may be asking: how do we go about designing effective ESG-linked incentive plans? Approaches for doing so will differ depending on where a company is in its ESG strategic planning journey. ***The next article in our ESG series provides a framework for considering your organization's readiness for incorporating ESG into executive compensation plans. To ensure you receive future articles in this series, subscribe here.***

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[3] NYU Stern Center for Sustainable Business, ESG and Financial Performance, February 2021.