CADWALADER

Reports Highlight Benefits and Challenges of Linking Executive Pay to ESG Factors

March 10, 2023

By Jason Halper
Partner and Co-Chair | Global Litigation

By Sara Bussiere
Special Counsel | Global Litigation

Over the last three years, PwC and the Leadership Institute at the London Business School have studied the prevalence and efficacy of linking executive pay to ESG-related goals or targets. Their first two reports—**Paying well by paying for good**, on the "academic evidence around ESG in pay" (published in 2021), and **Paying for good for all**, on investors and senior leaders' "expectations and experience of linking pay to ESG" (published in 2022)—found that investors and executives overwhelmingly support linking pay to ESG-related targets, with 82% of senior leaders (most commonly leaders of U.S. public companies) having ESG targets as part of their compensation. The most common ESG targets are tied to a company's overall strategy and relate to employee engagement or health and safety issues (56% of targets, each), followed by targets relating to diversity and inclusion (41% of targets) and decarbonization (35% of targets). Companies have adopted these targets in large part to achieve long-term value, signal "a broader set of priorities" important to investors, and "encourage[] companies to set short-term targets to meet long-term goals, especially for sustainability areas like net-zero." However, there is not consensus among executives and investors on how to structure and implement incentives. This is likely because, although research shows a "strong alignment between shareholder value and ESG outcomes," evidence of that alignment only tends to appear after a period of 5 years or more, which is "longer than the typical 1 to 3 year performance periods of executive pay."

The most recent report, **Paying for net zero**, issued this year, details findings from a study of incentives linked to carbon targets in 50 of the largest European listed companies. The report reveals that the vast majority of the companies reviewed have adopted some form of carbon

target in executive pay, and an even higher percentage met their targets. In 2022, payouts tied to carbon targets averaged 86%, with more than half of the companies reviewed paying 100% of the incentives.

However, the study analyzed these targets to determine whether pay incentives are meeting investor expectations by analyzing the targets against four criteria, namely, whether the targets:

(i) were **significant**, meaning "[a] separate and meaningful percentage of incentives linked to pay, so that management care about the measure;"

(ii) were **measurable**, meaning "[o]bjective and quantifiable targets, so that management are held to account;"

(iii) were **transparent**, meaning "[e]xternally clear and prospectively disclosed targets, so that the goalposts can't move;" and

(iv) **disclosed a link to long-term carbon goals**, meaning "[c]learly explained link between pay targets and stated carbon strategic goals, creating a clear bridge between the short and long term."

According to the study, "the measures [that companies] most commonly failed to meet relate to the weighting (which is frequently quite low), the transparency of targets (which are rarely prospectively disclosed), and their quantitative link to the company's stated long-term carbon reduction goals (which is often unclear)." Notably, the report found that the larger carbon emitters more often link executive pay to carbon emissions, which "suggests that focus[ed] investor engagement through, for example, the Climate Action 100+ ('CA 100+') group is having an impact." But the report also highlights the complexities of linking executive pay to carbon targets while offering suggestions for improvement.

Taking the Temperature: As the 2022 Paying for good for all report highlights, "investors and senior leaders agree on quite a lot," including "that a focus on ESG factors will generally lead to long-term improvement in financial performance and shareholder value" and that pay incentives will "help[] executives focus on short-term and non-financial factors that lead to long-term shareholder value but may conflict with short-term profit." These reports offer helpful data and practical guidance for boards adopting or implementing incentive pay tied to decarbonization or other climate-related goals.

Also, these findings evidence a seemingly widely-held view that ESG-related issues affect long-term shareholder value, and therefore, from a governance perspective, it is important for directors to consider and address ESG-related issues, despite (in the U.S.) the view often articulated from one side of the political aisle that consideration of these issues is inappropriate in various investment and other contexts.