ESG AND EXECUTIVE REMUNERATION – DISCONNECT OR GROWING CONVERGENCE?

A WHITE PAPER FROM **FTI CONSULTING** AND **CGLYTICS**

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Our findings indicate that further integration of ESG issues into executive pay may be needed to ensure pay structures align with long-term strategy.

FTI Consulting is an independent global business advisory firm dedicated to helping organisations manage change, mitigate risk and resolve disputes: financial, legal, operational, political & regulatory, reputational and transactional. Founded in 1982, FTI Consulting offer the full range of strategic communications and corporate governance advisory services covering: capital markets, investor relations, financial communications, corporate governance, ESG advisory, activism advisory, crisis management and public affairs. FTI Consulting is listed on the NYSE and employs 5,000 people across offices in 76 cities around the world.

Much like remuneration, regardless of sector, companies cannot get away from ESG. With a significant number of companies set to seek approval of a remuneration policy in 2020, there may be a window for Boards to start linking a greater proportion of pay to long-term ESG performance. While approaches will vary by company, ensuring healthy dialogue with stakeholders in the lead up to implementing any changes is of paramount importance. The research we have produced with CGLytics can act as a conversation starter for Boards and investors.

PETER REILLY
Senior Director, Corporate Governance

CGLytics is transforming the way corporate governance decisions are made. Combining the broadest corporate governance dataset, with the most comprehensive analytics tools, CGLytics empowers corporations, investors and professional services to instantly perform a governance health check and make better informed decisions. From unique Pay for Performance analytics and peer comparison tools, to board effectiveness insights, companies and investors have access to the most comprehensive source of governance information at their fingertips – powering the insights required for good modern governance.

Investors are increasingly focused on ESG practices as part of their investment decision-making processes. It has moved from being a niche investment strategy to mainstream and a fundamental part of how investors review, and value companies. We expect to see it being linked to executive performance evaluations and compensation more and more. If companies and their compensation committees don't have the right resources to prepare and proactively engage on these topics, they potentially expose their company to financial and reputational risks.

ANIEL MAHABIER
Chief Executive Officer

EXECUTIVE SUMMARY

The last decade has seen a steady increase in the focus on Environmental, Social and Governance (ESG) factors from a range of stakeholders and that growing scrutiny appears to have reached a crescendo over the past 18 months. Only the topic of executive remuneration continues to be discussed as frequently as ESG.

FTI & CGLytics have conducted an analysis to determine whether these two topics are increasingly converging. While there is evidence that the number of companies including some form of ESG-related measures in incentive plans has grown, the proportion of overall pay determined directly by performance against ESG criteria remains at the margin.

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INTRODUCTION

In recent years, the level of capital flowing into funds that incorporate ESG criteria has grown considerably and what was once an issue on the fringes of investment is increasingly part of the material financial analysis of a company's value.[1]

Consequently, ESG rating agencies (who help investors identify ESG risk) have grown in prominence; regulators have commenced a clampdown on so-called "greenwashing"[2]; and, investors continue to pressurise companies to provide greater details on ESG factors likely to affect their business – either through engagement or, less frequently, shareholder proposals. Indeed, a recent report found that, at least based on publicly disclosed documents, climate change was the number one issue for institutional investors in their stewardship of investee companies.[3]

In this paper, we have analysed whether the ratcheting up of pressure on companies to enhance their ESG frameworks has permeated another important area – executive remuneration at UK and Irish companies. For three decades, pay has been identified as a key driver of C-suite behaviour. Despite what appears to be a relentless focus on ESG, the incorporation of ESG measures into executive pay packages has lagged somewhat.

While there has been a rise in the prevalence of such measures, they remain on the periphery. Only 27.4% of FTSE 350 and ISEQ 20 companies have included some form of measurable ESG criteria in incentive plans. Even at those companies, however, the proportion of pay being driven by ESG performance is small.

This is despite companies across Europe being required to include non-financial statements in their Annual Reports; and, every FTSE 350 company being expected to set out non-financial Key Performance Indicators (KPIs) in their Annual Reports. If a group of KPIs are not being replicated in incentive plans, there may be a danger that remuneration frameworks are becoming disconnected from corporate strategy. Or do Boards and investors see ESG measures as effective risk management tools as opposed to opportunities to drive value?

> *"If a group of KPIs are not being replicated in incentive plans, there may be a danger that remuneration frameworks are becoming disconnected from corporate strategy."*

[1] From 2016-2018, assets subject to ESG integration investment strategy grew by 69%, from $10.4 to $17.5 trillion; The Global Sustainable Investment Alliance, *2018 Global Sustainable Investment Review.*

[2] https://europa.eu/rapid/press-release_IP-19-1571_en.htm.

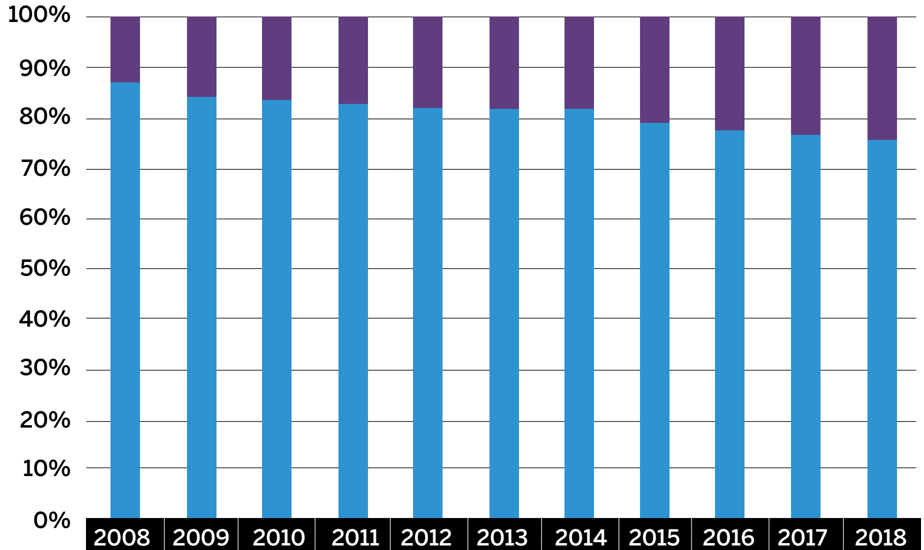
[3] EY, Turning the tide to greater corporate accountability (2019).

NON-FINANCIAL MEASURES

In developing incentive programmes, companies are increasingly detailing the link between KPIs and the incentive measures employed under bonus plans and long-term incentive plans (LTIPs). Specifically, in Strategic Reports, we have observed a growing tendency for companies to explicitly link KPIs to one or more incentive plan; and, vice versa in the remuneration report.

While there is room for improvement in this area of disclosure, that is the essence of any incentive structure – to motivate management to pursue the delivery of strategy and create long-term value for shareholders. Over the ten-year period 2008-2018, there was a recognition from the market that incentivising the delivery of strategy would need to incorporate non-financial measures, with the average weighting of those measures more than doubling over that period:

Financial/Non-financial weighting ratio for STI plans

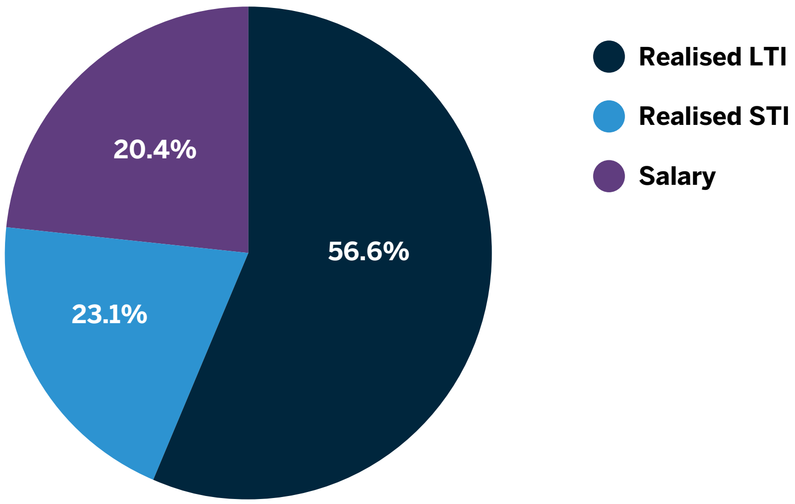


	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Non-Financial STI	12%	16%	17%	17%	18%	18%	19%	21%	22%	24%	25%
Financial STI	88%	84%	83%	83%	82%	82%	81%	79%	78%	76%	75%

Source: CGLytics Corporate Governance Data & Analysis

That trend has not been replicated under LTIPs, which tend to account for a far greater proportion of executive remuneration. For example, in the FTSE 350, over the three-year period of 2016-2018, LTIPs were worth **more than twice** bonuses and were more valuable than salaries and bonus combined.

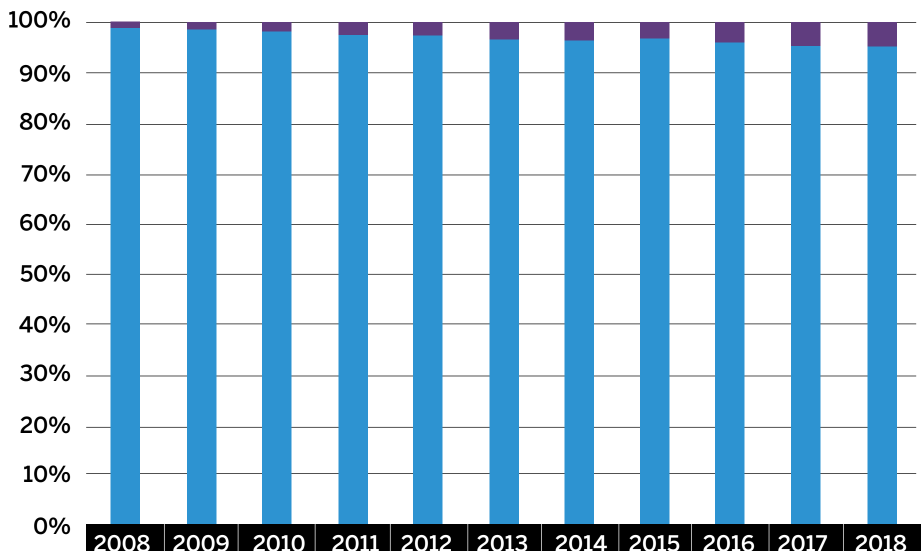
Executive Pay: Base salary/STI/LTI 2018



Source: CGLytics Corporate Governance Data & Analysis

Although growing, only a small percentage of companies include non-financial measures in LTIPs, dictating that the vast majority of remuneration remains linked to accounting measures, adjusted financials or TSR measures:

Financial/Non-financial weighting ratio for LTI plans



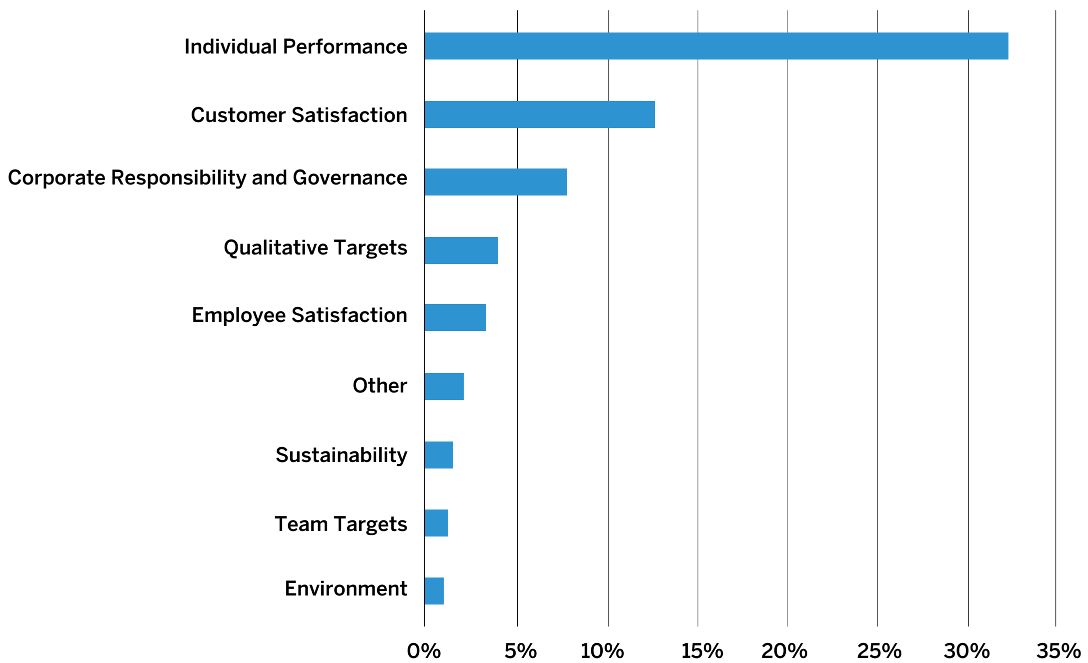
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Non-Financial LTI	1%	1%	2%	2%	2%	3%	3%	3%	4%	4%	5%
Financial LTI	99%	99%	98%	98%	98%	97%	97%	97%	96%	96%	95%

Source: CGLytics Corporate Governance Data & Analysis

QUALITATIVE VERSUS QUANTITATIVE

The growing prevalence of non-financial measures under bonus plans should not be mistaken for trackable, ESG-related measures. In the majority of cases, bonus plans include qualitative objectives related to strategic and personal performance; and, pay-outs tend to be accompanied by a narrative description of performance, as opposed to the staggered pay-out schedule associated with financial measures.

% of companies using non-financial KPI's



Source: CGLytics Corporate Governance Data & Analysis

[4] EU: Directive 2014/95/EU of The European Parliament and of The Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups; UK: Strategic report as required by The Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013 (the 'Regulations'). The Companies, Partnerships and Groups (Accounts and Non-Financial Reporting) Regulations 2016; and The Companies (Miscellaneous Reporting) Regulations 2018.

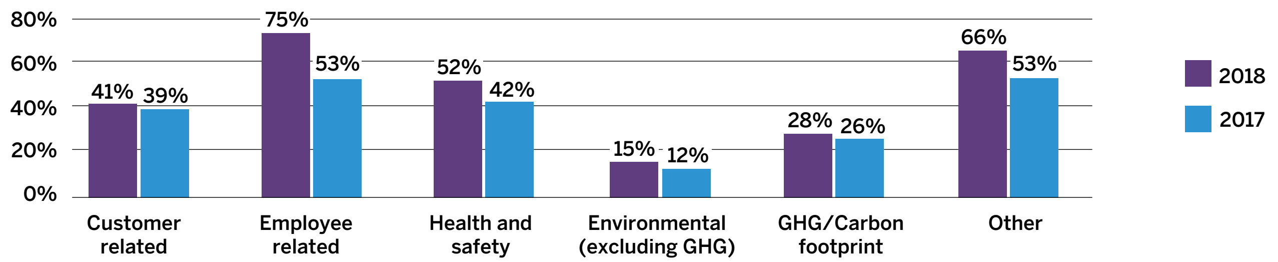
Through a combination of European and UK legislation, UK and Irish companies are required to provide relatively extensive details on non-financial performance factors[5] in their strategic reports, which may lay the groundwork for greater inclusion of ESG measures in incentive plans. As the Financial Reporting Council states:

Non-financial KPIs provide insight into future financial prospects and progress in managing risks and opportunities. They may include, for example, measures related to product quality, customer complaints, environmental matters or employee metrics.

Non-financial KPIs may be a mixture of indicators which provide information about what the entity has done in the past and what may happen in the future. They should include matters potentially affecting the long-term sustainability of the entity[6].

On average, FTSE 100 companies detail six non-financial KPIs, while FTSE 250 companies provide three, with the most popular of those measures – at companies where they are disclosed – being[7]:

Common types of non-financial KPI's (for those with such metrics)



Source: CGLytics Corporate Governance Data & Analysis

Such non-financial KPIs can provide an opportunity for Boards to assess whether incentive schemes need rebalancing to focus the minds of management on factors outside of 'bottom-line' numbers. Companies may argue this has already taken place through the integration of qualitative non-financial measures; however, while those measures continue to have a place in incentive plans, there may be a chance for Board's to supplement them with measurable ESG-related metrics that replicate trackable non-financial KPIs.

Annually, thousands of companies expend significant energy engaging with their shareholders, ESG rating agencies, and ESG-related surveys in an effort to enhance the perception of their ESG credentials, associated scoring and to gain inclusion to certain indices. While each remain an important part of a company's story, it may be that Boards are resourcing ESG efforts without necessarily placing sufficient emphasis on incentivising management to pursue those same goals.

[5] EU: Directive 2014/95/EU of The European Parliament and of The Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups; UK: Strategic report as required by The Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013 (the 'Regulations'). The Companies, Partnerships and Groups (Accounts and Non-Financial Reporting) Regulations 2016; and The Companies (Miscellaneous Reporting) Regulations 2018.

[5] Financial Reporting Council, Guidance on the Strategic Report. July 2018.

[7] Deloitte, Annual Report Insights 2018.
Available at: https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/audit/deloitte-uk-audit-annual-report-insights-2018.pdf

MARKET VIEW – INVESTORS ON ESG

In both their marketing materials and their proxy voting guidelines, the world's largest asset managers detail the importance of ESG to their investment strategies and approach to issuer engagement.

In that sense, for major institutional investors, the focus on ESG is doubly important. As asset owners demand more answers regarding the role ESG plays in investment decisions, it becomes increasingly central to attracting inflows and gaining market share while simultaneously reducing risk, or even driving superior investment returns.[8] This trend is likely to continue as the EU implements more stringent measures requiring institutional investors to report on the impact of their investments to ultimate asset owners.[9] In their public guidelines on investment and proxy voting, State Street and Legal & General refer to the importance of ESG; while Blackrock goes a step further and addresses the idea of incorporating ESG measures into incentive plans – albeit with a cautionary tone.

State Street: *We engage with companies to provide insight on the principles and practices that drive our voting decisions. We also conduct proactive engagement to address significant shareholder concerns and environmental, social, and governance ("ESG") issues in a manner consistent with maximizing shareholder value.*[10]

Legal & General: *Assessing companies on their management of Environmental Social & Governance (ESG) issues is an important element of risk management, and therefore part of investors' fiduciary duty. By incorporating ESG factors into investment decisions, we believe investors can gain an element of protection against future risks and the potential for better long-term financial outcomes. This is why we embed both top-down and bottom-up ESG analysis into our investment processes.*[11]

Blackrock: *The performance measures should be majority financial and at least 60% should be based on quantitative criteria. Variable pay should be based on multiple criteria. We expect full disclosure of the performance measures selected and the rationale for the selection of such performance measures. If the board decides to use ESG-type criteria, these criteria should be linked to material issues and they must be quantifiable, transparent and auditable. These criteria should reflect the strategic priorities of the company. For that reason, the inclusion in ESG-indexes is generally not considered to be appropriate criteria. Where financial measures constitute less than 60% of performance measures a cogent explanation should be provided.*[12]

While the level of discourse and company reporting on ESG has grown recently, incorporating ESG or sustainability measures into incentive plans is not a new idea. In 2012, a Task Force for the UN PRI, comprised of some of the world's leading investors, published a paper entitled *Integrating ESG Issues into Executive Pay*.[13] That paper aimed to provide guidance for investors and companies on how best to incorporate ESG measures into short and long-term executive remuneration.

With institutional investors and other key market players demanding greater attention is paid to ESG factors, it appears that Boards have not yet fully reacted by implementing changes to the frameworks designed to drive executive behaviour – incentive schemes. As regulatory pressure grows on investors to demonstrate the ESG credentials of their investments, we anticipate greater pressure from investors on companies to align management incentives with ESG related metrics.

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[8] Clark, G.L., Feiner, A. & Viehs, M., 'From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance', 5 March 2015. Available at SSRN https://ssrn.com/abstract=2508281; Deutsche Asset and Wealth Management, 'ESG and Corporate Financial Performance: Mapping the global landscape', December 2015 https://institutional.deutscheam.com/content/_media/K15090_Academic_Insights_UK_EMEA_RZ_Online_151201_Final_(2).pdf; Gompers, P.A., Ishii, J.L. & Metrick, A.,'Corporate Governance and Equity Prices', Quarterly Journal of Economics, Vol. 118. No. 1, pp. 107 155, February 2003; Edmans, A., 'Does the stock market fully value intangibles? Employee satisfaction and equity prices', Journal of Financial Economics 101 http://faculty.london.edu/aedmans/Rowe.pdf; Derwall, J., Guenster, N., Bauer, R., & Koedijk, K., 'The Eco-Efficiency Premium Puzzle', Financial Analyst Journal, pp. 61-2 https://www.cfapubs.org/doi/abs/10.2469/faj.v61.n2.2716; Harrison, H. & Kacperczyk, M., 'The price of sin: The effects of social norms on markets', Journal of Financial Economics, pp. 93-1 https://www.sciencedirect.com/science/article/pii/S0304405X09000634; Corporate Sustainability: First Evidence on Materiality, The Accounting Review 91-6 http://aaajournals.org/doi/10.2308/accr-51383; 'The materiality of ESG factors for equity investment decisions: academic evidence', NN Investment Partners and ECCE report, 2016 https://yoursri.com/media-new/download/ecce_project_the_materiality_of_esg_factors_for_equity_investment_decisi.pdf; https://spilplatform.com/wp-content/uploads/2017/02/SPIL-The-Financial-Returnof-Responsible-Investing.pdf

[9] Proposal for a Regulation of the European Parliament and of the Council on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341

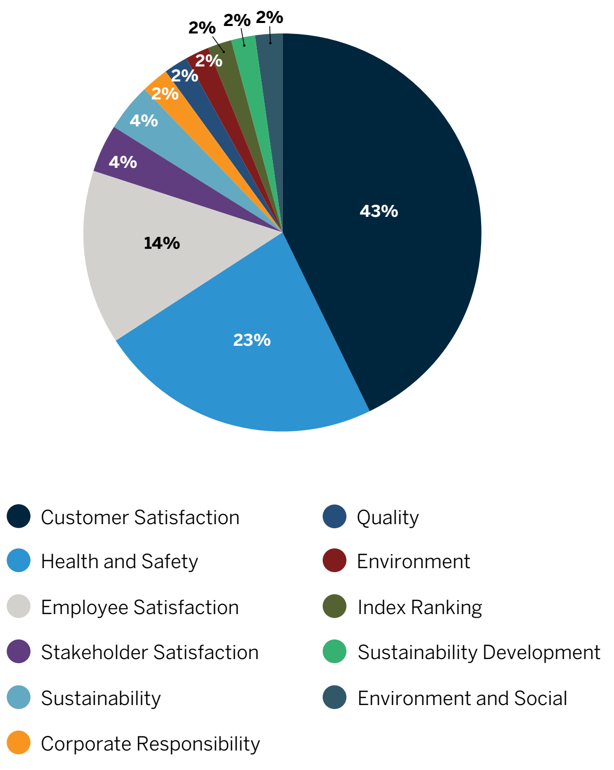
[10] SSGA, 2019 Proxy Voting and Engagement Guidelines: Europe; available at: https://www.ssga.com/our-insights/viewpoints/2019-proxy-voting-and-engagement-guidelines-europe.html

ESG MEASURES & CASE STUDIES

Most Common ESG-related Measures

Despite the focus of regulators and investors, the integration of ESG measures into incentive plans has been progressing slowly – perhaps unsurprisingly given how rapidly the issue has come to the fore. From a review of FTSE 350 and ISEQ 20 companies from 2018 reporting, only 12.8% of UK and Irish companies have included 'strict' ESG measures in their incentive frameworks. This figure increases to 27.4% when customer satisfaction is included. While there is likely to be debate as to the ESG 'credentials' of customer satisfaction, any metric that measures management performance on engaging with a stakeholder group merits – in our view – inclusion:

Most common ESG/CSR non-financial indicator 2018



Source: CGLytics Corporate Governance Data & Analysis

While almost three-quarters of companies do not yet include ESG-related measures, there has been a marked increase in their use over the past decade:

- In 2008, 4.3% of companies included ESG related KPIs in bonus plans; and,
- In 2013, 19% of companies included ESG related KPIs in bonus plans.

Nonetheless, ESG measures continue to account for a tiny proportion of potential remuneration for the UK and Ireland's listed companies; and, even at the 27.4% of companies incorporating them, they are often a very small portion of bonuses. On average, at the 27.4% of companies, ESG-related measures account for less than 15% of bonuses.

Despite the consistent focus on climate change, certain stakeholders will likely be disappointed to see the slow pace at which environmental targets are Integrated into incentive plans by companies. Of all potential ESG measures, reducing the impact on the environment seems to be one of the easier to include in incentive plans, as there are a number of metrics employed in measuring emissions, single use plastics and water usage, among others. Notably, such measures are far more frequently referred to as non-financial KPIs.

Having come under pressure from a coalition of investors, commitments from Shell and BP to incorporate climate-related measures into their incentive schemes over the coming year will further increase the number of companies adopting environmental performance targets into incentive plans. It is likely that this trend will gather pace, and not just in material intensive industries. Over the past year, there has been increasing pressure on financial institutions to detail their approach to lending and green finance[14], while companies in the agricultural and transport sectors are also under heightened scrutiny – in line with wider societal pressures. As businesses come under increased pressure to detail – and then reduce – their impact on the planet, there will be few sectors that escape investor spotlight.

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[11] LGIM, Corporate Governance and Responsible Investment Policy; available at: https://www.lgim.com/files/_document-library/capabilities/lgim-uk-corporate-governance-and-responsible-investment-policy.pdf

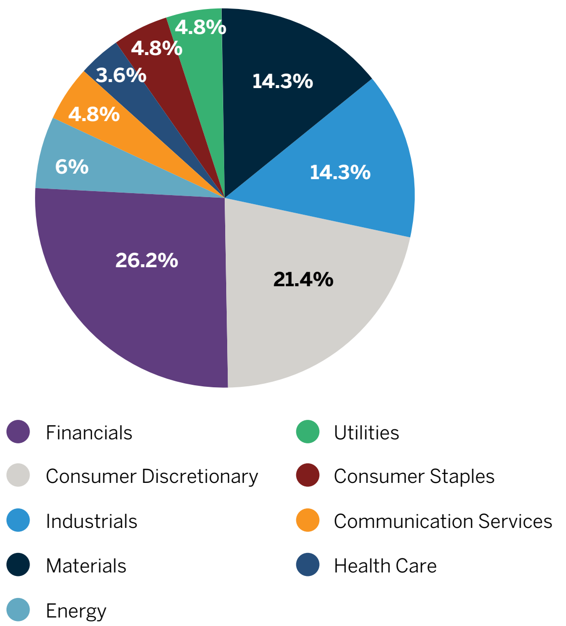
[12] Blackrock, Proxy voting guidelines for European, Middle Eastern, and African securities, 2019; available at: https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-guidelines-emea.pdf

[13] UN PRI, Integrating ESG issues into executive pay: a 2012 report, available at: https://www.unpri.org/download?ac=1878

[14] Rainforest Action Network, Banking on Climate Change, 2019. Available at: https://www.ran.org/wp-content/uploads/2019/03/Banking_on_Climate_Change_2019_vFINAL1.pdf

ESG MEASURES & CASE STUDIES

Sector analysis – ESG related KPIs 2018



Source: CGLytics Corporate Governance Data & Analysis

While the 'E' in ESG is key in certain sectors, in others, the 'S' is to the fore. Whether it be in employee heavy industries; those where Health & Safety is paramount; or, where the workforce is the company's most important intellectual property, an engaged workforce has consistently been shown to improve productivity and risk management.[15]

Engaged employees are those fully invested in their firm and their work. They are the ones who actively think about the firm's processes – and identify improvements. Their enthusiasm reflects a corporate culture that encourages engagement. Most importantly, they are productive. Conversely, disengaged workers impact productivity and value creation, but are also a risk which can permeate throughout the organisation. Consequently, it is not surprising to see employee engagement and satisfaction used in a relatively high number of incentive plans, as well as being one of the most prominent non-financial KPIs. It is likely that this measure will become more prevalent in incentive plans for a number of reasons: since 1 January 2019, UK & Irish companies have been required to increase their focus on employee engagement under the new UK Corporate Governance Code; in the search for quantitative ESG-related measures, there are a number of established workforce metrics; and, there appears to be a growing recognition from Boards and management of the importance of favourable employee policies.

Supplementing those metrics with qualitative assessments would aid investors' understanding of the importance of employee engagement to Boards. In this space, the Pensions and Lifetime Savings Association (PLSA), the UK trade body, and ShareAction, the responsible investment campaign group, have developed two separate tools (Understanding the Worth of the Workforce[16] and the Workforce Disclosure Initiative, or WDI) to assist with this type of analysis[17].

Ease of measurement may have presented challenges for companies and investors, causing the E- and G-factors to gain more traction than the S-factor initially, which had often been confined to employment rights. The S does not stop at employees, however, and extends to how companies interact with wider society. Social and human capital issues are on the rise, as diversity, data privacy, and the treatment of labour in supply chains are looked at with a closer lens. Meanwhile, pharmaceutical companies are facing pressure from a number of stakeholders, as drug pricing and wider impacts on society become hot button issues.

[15] Alex Edmans, Does the stock market fully value intangibles? Employee satisfaction and equity prices, Journal of Financial Economics 101 (2011) 621–640

[16] https://www.plsa.co.uk/Policy-and-Research/Document-library/Understanding-the-worth-of-the-workforce-a-stewardship-toolkit-for-pension-funds

[17] https://shareaction.org/wdi/

Case Studies

As with any analysis of over almost 400 companies, certain market leaders jump out. While each company should analyse the ESG-measures most important to its own strategy and long-term performance, examples from the market – and their sector – can be useful for companies when considering how best to integrate ESG-related measures in incentive plans, if at all. The following are four companies that have included more than one ESG measure in their remuneration framework:

Drax Group	Electricity	FTSE 250

Drax's incentive framework is heavily focused on a Group Scorecard, which accounts for the entirety of bonus payouts and half of vesting under the LTIP. Within the scorecard, Safety performance accounts for 10%, and is supplemented by a sustainability measure. The sustainability measure is assessed under the three elements of people, reputation and the sustainability of biomass fuel, with performance against three KPIs combined into a single score. Significantly, Drax's sustainability plan was subject to an independent audit. The scorecard also includes a focus on biomass, which may provide a renewable alternative to traditional fuels.

DETAILS OF PERFORMANCE AGAINST METRICS FOR VARIABLE PAY AWARDS

Annual bonus plan outcome

A summary of the Committee's assessment in respect of the 2018 Group Scorecard is set out in the following table:

	Weighting	Low target	Target	Stretch target	Outturn	Score
SAFETY						
Total recordable injury rate	10%	0.27	0.22	0.15	0.22	1.0
FINANCE						
Group Adjusted EBITDA (£m)	30%	229	251	289	250	1.0
Group net debt (£m)	5%	(422)	(400)	(362)	(319)	2.0
Progress on delivering strategy (Performance vs plan)	10%	Approaching Plan	On Plan	Ahead of Plan	Approaching Plan	1.3
SUSTAINABILITY						
People, reputation & responsibility (Performance vs plan)	5%	Approaching Plan	On Plan	Ahead of Plan	Approaching Plan	0.9
PELLET PRODUCTION						
Fines at Disport (%)	7.5%	7.5%	6.5%	5.5%	8.0%	0.0
Cost of production ($/GJ)	7.5%	10.90	9.82	8.35	9.37	1.2
POWER GENERATION						
Biomass unit technical availability (%)	5%	ND	ND	ND	90.7%	2.0
Value from Flexibility (£m)	5%	63	78	93	79	1.0
B2B ENERGY SUPPLY						
Cost to serve customers (£/MPAN)	5%	ND	ND	ND	ND	2.0
Quality of business (£/MWh)	5%	ND	ND	ND	ND	0.0
Growth in market share %	5%	0.6%	0.9%	1.2%	0.8%	0.8
TOTAL WEIGHTING/SCORE	**100%**					**1.05**

ESG MEASURES & CASE STUDIES

Barratt Developments	Housebuilder	FTSE 100

Barratt Developments' annual bonus plan is one that ascribes an equal value to health, safety and customers service as it does to margin improvement. The H&S measure relies on audit software, while customer service must be maintained at 90% across divisions, driving management to focus on the quality and safety of the homes being built.

Bonus target	Strategic objective	Targets	Potential bonus weighting % of salary	Actual performance achievement	Bonus achieved % of salary
Profit before tax	Support profitability	Threshold: £835.0m Target: £850.0m Maximum: £900.0m	16.50% 41.25% 82.50%	£909.8m	82.5%
Quality and service improvement	To create a quality product that customers recommend in a safe way for our employees and stakeholders	Divisions to achieve SHE Audit of 94% and customer service recommend score of 90%. Target assessed by number of divisions meeting both targets.	22.5%	SHE 27/27 divisions Customer service 26/27 divisions	21.67%
Strategic objective – margin improvement	To deliver an improvement in regional trading margin to support the profitability of our business	Threshold: 25.8% Target: 26.1% Maximum: 26.5%	7% 11.25% 22.5%	26.7%	22.5%
Strategic objective – trading outlets	To deliver the optimum number of trading outlets to ensure growth and delivery of our business plan	Threshold: 154 Target: 158 Maximum: 161	3.0% 3.75% 7.5%	163 outlets	7.5%
Personal objectives	To focus individuals on achieving the Group's strategic objectives	See Table 18	3.0% 7.5% 15.0%	See Table 18	See Table 18

OneSavings Bank	Banking	FTSE 250

Under OneSavings' bonus scheme, a mix of quantitative ESG-related measures have been incorporated – focusing on key stakeholder constituencies. While many companies incorporate diversity as part of qualitative, non-financial measures, OneSavings goes a step further and links pay-outs to firm targets *"based on gender diversity of the senior leadership team."* Likewise, each of the customer, broker and staff metrics are based on firm targets. While some may argue that these measures are easier to hit than hard financials, given the link between a bank's interaction with stakeholders and its license to operate, it would have the impact of focusing the minds of management.

EXECUTIVE BONUS SCHEME: 2018 PERFORMANCE AGAINST THE BUSINESS BALANCED SCORECARD (AUDITED)

		TARGETS					
Category	Key performance indicator	Threshold (25%)	Budget (50%)	Max (100%)	Actual result	Outcome CEO (%)	Outcome CFO (%)
Financial (50%)	Underlying PBT	£172m	£176m	£184m	£193.6m	50	50
	All-in ROE	22.7%	23.7%	25.7%	26.0%		
	Cost to income ratio	31.6%	30.6%	28.6%	28.2%		
	Net loan book growth	17.4%	18.4%	20.4%	22.9%		
	CET1 ratio	<12%	12.0%	>13%	13.3%		
Customer (15%)	Customer satisfaction	35	40	50	63	12	12
	Broker satisfaction	27.5	30	35	28		
	Complaints	0.8%	0.5%	0.1%	0.1%		
Quality (15%)	Overdue actions	3	2	<1	2	11.25	11.25
	Arrears	1.25%	1%	0.50%	0.66%		
	High-severity incidents	4	3	1	1		
Staff (10%)	Diversity	26%	27%	29%	28%	9	9
	Employee engagement	3	4	6	6		
Personal (10%)	Vary by executive–see section below					9.5	9
Total						**91.75**	**91.25**

ESG MEASURES & CASE STUDIES

Tesco	Supermarket	FTSE 100

As part of a response to concerns regarding corporate culture, Tesco's Board implemented extensive changes to the incentive arrangements in order to place a focus on interactions with three key stakeholders – suppliers, employees and customers. Bucking the trend, Tesco's Remuneration Committee placed the *"key stakeholder measures"* under the LTIP:

At 20% of the LTIP, pay-outs under these measures could reach 55% of salary for the CEO – indicating a firm commitment to motivating management to enhance engagement with key stakeholders.

PSP MEASURES

Performance measure	Weighting	Definition of measure
Relative TSR vs index comprising companies from FTSE350 Food & Drug Retailers and FTSE350 General Retailers indices	50%	Growth in share price plus dividends reinvested. These incorporate Tesco's key competitors within the FTSE350 Food & Drug Retailers and FTSE350 General Retailers indices. The groups are weighted towards the Food & Drug Retailers to reflect Tesco's long-term business split between food and general retail.
Retail cash generated from operations	30%	Cumulative retail cash generated from operations +/- movement in working capital, excluding Tesco Bank
Key stakeholder measures	20%	Three stakeholder metrics: customers, suppliers and colleagues

RESTRICTED SHARES

While the majority of companies have not integrated ESG-related measures into incentive schemes, the numbers doing so are increasing. This trend, however, has been almost exclusively confined to short-term incentive schemes, despite ESG being positioned by many as the ultimate in long-term protection of shareholder value. And so, the question is whether ESG-related measures would not be more at home in LTIPs, which include a longer vesting period and where the majority of remuneration lies. It may, however, be the case that strong ESG performance will take so long to be reflected in performance and share price that incentive plans of three to five years are mismatched with the idea of including such metrics. Here, some have argued Restricted Shares have a role to play.

Once thought of as being deficient in aligning pay and performance, the Investment Association's working group revived the idea of Restricted Shares in 2016[18]. The idea was that both the time spent on trying to craft the perfect measures for business and how imperfect those same measures can be, meant that simply making senior executives' long-term shareholders would be the most effective way to spur long-term thinking; and, align their interests with those of long-term shareholders.

In short, remove the distractions of complicated pay schemes and allow executives to focus on the day-to-day of running the business.

The more effectively they do so, the higher the value of their restricted shares will be upon vesting – and if the holding periods for awards are sufficiently lengthy, ESG factors, such as strong governance; employee productivity; supplier satisfaction; and, robust environmental protections would all serve to enhance the value of companies and the equity holdings of management. Maybe the same argument could be made in favour of traditional financial incentives, that the focus on ESG factors will eventually have a positive impact on the bottom line, dictating that there is no need to explicitly include them in incentive plans. However, given that only a handful of UK & Irish companies have opted for Restricted Shares, it may be a case that ESG-related measures become part of traditional incentive frameworks, rather than being a factor in companies opting to include a Restricted Share Scheme.

[18] Investment Association, Executive Remuneration Working Group Final Report, July 2016. Available at: https://www.theia.org/sites/default/files/2019-05/ERWG%20Final%20Report%20July%202016.pdf

CHALLENGES

One of the criticisms of executive pay generally has been of excessive uniformity, whereby companies have ended up with similar incentive schemes, despite being of completely different size and operating in completely different sectors.

There is a risk of that happening here too, with a set of ESG KPIs being adopted across the board, without the level of nuance required to extract value from utilising the 'right' measures.

There are challenges for boards in considering the how – the number of possible sustainability improvement goals grows by the day, while the long-term efforts to realise payback from most ESG initiatives don't easily fit into the usual annual or three-year incentive timeframes. However, the same could be said for investing in the workforce or R&D and it should not mean companies do not attempt to spur a greater focus on the long-term.

UK and Irish companies are already providing extensive disclosure of non-financial factors in their Annual Reports. It makes sense that the process of due diligence around detailing non-financial KPIs and risks can be replicated in setting performance measures for remuneration. The effort to determine what are material risks and indicators of performance should result in the streamlining of what measures can prove valuable to individual companies. Importantly, according to research in 2016, companies with good performance across all aspects of sustainability do not beat the market,[19] while the average socially responsible investment fund underperforms.[20]

However, that is an overly simplistic view, and companies that perform well on sustainability issues that are material to their industry — environmental factors for the mining industry, data security for the tech sector and impact on communities for housebuilders — and show restraint on ones that are not, tend to deliver higher returns than their peers.[21]

Much like financial measures, the judicious selection of what matters to an individual company is a challenge for Remuneration Committees; however, with a number of processes already in place to identify what the key non-financial risks and performance indicators are, it may well be as much about building on existing capabilities as it is about starting from scratch.

> “*The effort to determine what are material risks and indicators of performance should result in the streamlining of what measures can prove valuable to individual companies.*”

[19] Mozaffar Khan, George Serafeim, and Aaron Yoon Corporate Sustainability: First Evidence on Materiality. The Accounting Review: November 2016, Vol. 91, No. 6, pp. 1697-1724.

[20] Luc Renneboog Jenke Ter Horst Chendi Zhang The price of ethics and stakeholder governance: The performance of socially responsible mutual funds. Journal of Corporate Finance Vo. 14, Issue 3, June 2008, pp.302-322

[21] Mozaffar Khan, George Serafeim, and Aaron Yoon

OUTLOOK

The direction of travel in terms of ESG is clear.

A recent survey from BNP Paribas found that 65% of investment frameworks are now aligned to the UN Sustainable Development Goals[22]; a report from UBS indicated that environmental factors could outstrip financial analysis over the next five years[23]; and, Fitch Ratings pointed to a 15% growth in ESG funds during the first half of 2019.[24] That focus is starting to impact issuers – a FactSet study found that there was growth in the numbers of US companies referring to ESG factors in results presentations from Q1 to Q2 of 2019.

Twenty-four companies in S&P 500 mentioned the acronym "ESG" on earnings conference calls between June 15 and Sept. 14, double the number that cited the term in the first quarter.[25] While this is only 5% of the index, only two companies referred to ESG in the second quarter of 2017, indicating that Boards have accepted how far ESG has risen up investors' agenda in terms of financial materiality. As ESG factors become further embedded in regular roadshows and KPIs, it seems only a matter of time before they are integrated into incentive plans to a greater degree.

One factor that may act as a catalyst is the emergence of robust sustainability or ESG accounting measures. A key aspect of traditional accounting or adjusted financial measures is their uniformity – investors have a clear understanding of what profit, EPS and TSR are, and have developed expectations of how management should perform against those measures. Consequently, there is a level of comfort in electing to use fully established measures that everyone understands. Often those companies who have tried to be creative or do something outside the norm have been punished at their AGM. It is a particular challenge for ESG or sustainability measures, which by-and-large do not have accounting measures that can be relied on. However, that may well be beginning to change.

Towards the end of 2018, and after five years of consultations and deliberations with investors, issuers and academics, the Sustainable Accounting Standards Board (SASB) published updated standards for 77 industries.[26] Each set of standards provides quantitative and qualitative accounting measures applicable to companies in a particular industry.

While they are not exhaustive and are designed to focus the minds of issuers and investors, they are an indication of how much closer we are to accurately gauging the financial impact of ESG and sustainability. Perhaps more significantly, there appears to be a growth towards independent assurances of ESG and sustainability information. As investors increasingly rely on non-financial information to make investment decisions, the expectation that information has been audited may grow commensurately. According to a recent survey of Annual Reports, a quarter of companies referred to assurance of some non-financial or sustainability measures – most frequently in relation to ISO frameworks on Health & Safety and the environment. As companies employ assurance providers more frequently, it may be the case that quasi-audited non-financials begin to provide Remuneration Committees with a similar level of comfort they currently derive from traditional accounting measures.

As more companies put their heads above the parapet, it seems likely that the two hottest topics in corporate governance – ESG and executive remuneration – are set for increased convergence. Last week, BHP became the latest UK giant to announce it would be setting hard ESG-related targets under incentive schemes, following in the footsteps of Oil & Gas majors Shell and BP.

Some may argue that those steps will be confined to material intensive industries where the environmental impact is more pronounced. It is worth remembering when clawback, malus and bonus deferral were brought into banking incentive structures after the financial crisis, it was not long before they became ubiquitous at FTSE 350 companies – regardless of sector. The appetite for ESG varies significantly by investor and by company, and ESG-related measures may not become a staple of every companies' incentive framework; however, given the flow of capital towards ESG, and the regulatory focus on the same, they seem likely to become far more prevalent and weighted more heavily in the near future.

[22] BNP Paribas, ESG Global Survey 201: Investing with Purpose for Performance. Available at: https://cib.bnpparibas.com/sustain/esg-global-survey-2019-investing-with-purpose-for-performance_a-3-2900.html

[23] UBS, ESG: Do you or Don't you? https://www.ubs.com/global/en/asset-management/insights/sustainable-and-impact-investing/2019/esg-do-you-or-don-t you/_jcr_content/mainpar/toplevelgrid/col2/innergrid/xcol1/linklist/link.1558816091.file/bGluay9wYXRoPS9jb250ZW50L2RhbS9hc3NldHM-vYW0vZ2xvYmFsL2luc2lnaHRzL3N1c3RhaW5hYmxlLWFuZC1pbXBhY3QtaW52ZXN0aW5nL2RvYy9lc2ctcmVzcG9uc2libGUtaW52ZXN0b3IucGRm/esg-responsible-investor.pdf

[24] Fitch Ratings. ESG in Money Market Funds: Implicit to Explicit Transition Underway. Available at: https://www.fitchratings.com/site/re/10080958

[25] FactSet Insights. Available at: https://insight.factset.com/100-increase-in-sp-500-companies-citing-esg-on-earnings-calls-in-q2-vs.-q1

[26] https://www.sasb.org/standards-overview/

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