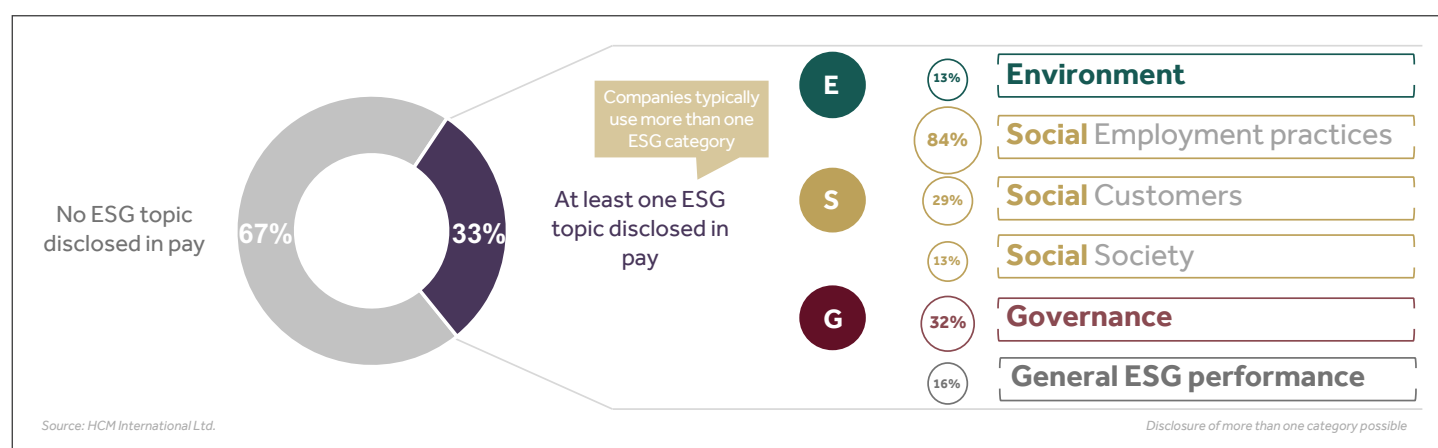


5 Myths of Linking ESG to Pay

ESG (environmental, social, and governance) topics have become omnipresent and our surveys show that current developments including the COVID-19 pandemic have further increased the ESG focus of investors, customers, employees, and the general public. Not only because these stakeholders want to do “good”, but also because they want to do “well” with ESG investments, which have shown a superior financial performance compared to “traditional”

investments. To signal the commitment towards ESG and to support the strategic implementation of ESG initiatives, companies increasingly link such topics to variable pay. In Switzerland, about one third of the Top 100 companies (per market capitalization) currently do so, which translates into a significant increase from only 13% in 2012 (see graph below). Within the large cap index (SMI), it is even two thirds of the companies.



5 Myths of Linking ESG to Pay

This trend is also dominant in the international field, especially in Australia, the UK, Canada, and other European countries. However, certain myths and misconceptions prevail:



“ESG is such a general topic that we cannot link it to pay”

While it is true that ESG encompasses a variety of topics, the goal lies in **identifying material topics** that are both relevant from the organization’s view as well as from a broader stakeholder angle instead of trying to be a leader in all ESG topics. Let’s take the financial service industry as an example: Next to increasing ESG product and service offerings, ESG has various inhouse implications such as diversity, ethics, and data security. These topics can be broken down into concrete initiatives, for example “measures to increase return-

to-work rate of new mothers/fathers” for diversity or “improve data protection by proactively educating clients” for data security. Similar to other strategic initiatives, the target achievement of such initiatives can then be measured and considered in variable pay.



“ESG is not objective and, therefore, not useful for pay decisions”

Significant improvements have been made in the measurement and reporting of ESG topics over the last years. Next to environmental topics, this is also true for the often harder-to-measure social and governance aspects. Nevertheless, ESG does (and should) include some level of **fact-based discretion**, especially to deal with potential conflicts of interest. Communicated well, fact-based discretion is usually not an issue for proxy advisors but even welcomed since it allows to better

reflect overall performance. Take carbon emissions, for example: While many companies will most likely reach their targets 2020 due to almost non-existing business travel and a reduction in overall production levels, decision-makers are well advised to consider the specific circumstances for potential up- or downward adjustments to pay. In fact, we observe that board discretion is continuously and increasingly used in the market.



"ESG topics will only penalize our executives"

Changes to remuneration systems are often accompanied by uncertainty and discomfort. However, decision makers can easily steal opponents' thunder when it comes to integrating ESG topics: Firstly, such metrics are **often already tracked and reported** within an organization. Secondly, including them typically allows for **both upward and downward adjustments** to pay, especially in short-term incentive plans (STI). The sweet spot lies in defining **company-tailored targets with a reasonable level of ambition**. One way to facilitate the discussion is by setting minimum requirements or long-term ranges per topic and calibrating the remuneration system in an effective way, supported by impactful communication to unfold its potential.



"ESG topics are redundant since they are already indirectly included in financial metrics"

Yes, it is true that ESG initiatives typically pay off for example via increased revenues or reduced costs over a

long-term horizon. However, current remuneration plans typically take a yearly view, or, in case of long-term plans, up to three years on average. ESG initiatives, however, realize their pay-off over a much longer view and most stakeholders expect executives to focus their attention on longer-term value drivers which, in turn, are explicitly linked to pay. Especially proxy advisors and institutional investors (e.g. BlackRock, GlassLewis, zRating, Ethos) increasingly take this view. Since most long-term incentive plans (LTI) are typically linked to financial metrics, companies are more likely to include ESG topics in STIs, similar to other non-financial topics. Though the inclusion in STIs can also be a powerful lever to **support behavioral change and manage strategic aspects** from year to year, we expect companies to **increasingly consider ESG topics in LTIs in the future**.



"Our line managers can already include ESG topics at their discretion in employee pay – that should be enough"

ESG topics are not new per se and many companies have already linked certain topics to pay. However, as recent years have shown, the bottom-up engagement needs to be supported by **top-down strategic decisions** for a long-term shift towards ESG. That is why stakeholders increasingly scrutinize **executive remuneration** for a link to ESG topics. Though the average weight of ESG metrics of 10-20% might not be considered a tremendous lever, it is still a prominent external signal that can be increased over time while **showing commitment and an adequate "tone from the top"**.

HCM, a fully independent advisor, works with publicly listed and privately-owned companies on ESG strategies from defining ESG focus topics and implementing appropriate governance processes to reflecting ESG topics in performance management and pay. Reach out to us.

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