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HCM Viewpoint

ESG by default: A game changer for strategy, governance and remuneration?

Explorative Study of ESG in the Swiss Financial Service Industry

GLOBAL GOVERNANCE AND EXECUTIVE COMPENSATION GROUP
New York • Los Angeles • London • Paris • Zurich • Geneva
Kiev • Beijing • Singapore • Melbourne • Sydney

Executive Summary

The analysis was focused on **whether and how ESG considerations are already implemented in strategy, governance and remuneration** with a special focus on encountered challenges and envisioned improvements.

Conduct an ESG Focus Process to analyze ESG topics and define current gaps and next steps:
Only 52% of the reviewed companies disclose key ESG topics with a main focus on social (100%) and governance (85%) topics.
Identifying what these topics mean for companies in the Swiss financial service industry not only in terms of external products and services but also regarding internal processes, is challenging – but essential for defining an organization's ESG approach.

Establish an appropriate ESG Governance Network by ensuring ESG expertise and diversity:
According to the interviews conducted, companies often struggle to define **where ESG plays a role internally and externally and how to derive concrete strategic goals and initiatives**.
While the definition of a long-term ESG strategy is ideally part of the Board's responsibilities, **only 36% of the analyzed companies disclose following this practice**. Approximately 28% also disclose having a separate Board committee on ESG in place. Below the Board, **52% of the companies disclosing active management of ESG topics at the executive level**.
To ensure the right "tone from the top", ESG should become an **anchored aspect of consideration in the regular strategic cycle** enabling the successful implementation of ESG initiatives through prioritization and clear communication cascaded throughout the organization.

Follow the ESG Capability Circle approach to support employee commitment:
Engaging employees at an early stage and communicating the expected benefits is key to realizing ESG strategies. By following a bottom-up approach we support the design of **stakeholder engagement strategies** and ensure that employees have sufficient **resources and capabilities** regarding ESG.

Establish an ESG Performance Map for tracking and reporting:
Investors and proxy advisors are increasingly scrutinizing **remuneration systems for the reflection of ESG topics** as a proxy to how credible ESG efforts are. **52% of the banks and insurers** in the HCM Top 100 Switzerland data set **disclose a link of ESG initiatives to variable pay**. Social topics, and especially topics related to employees, account for the largest share.
Breaking down ESG topics into yearly measurable KPIs is essential for setting the right tone from the top and ensuring appropriate priorities. Clear tracking and reporting also supports **credibility and reputation**.

ESG by default: A game changer for strategy, governance and remuneration?

Financial service companies are increasingly becoming aware of potential **regulatory changes** (e.g. the EU action plan on sustainable finance[1]) on ESG, i.e. environmental, social and governance topics. Also, the **needs of customers are changing** which have been further supported by the heighted ESG focus of global investors such as BlackRock[2]. The **increase in investors' attention on ESG** has also been confirmed in our recently published investor study together with our partners in the Global Governance and Executive Compensation Group (GECN Group)[3]. Last but not least, the recent COVID-19 pandemic has further shown how important long-term, sustainable business strategies can be.

While the financial service industry is typically quite advanced when it comes to regulatory topics, as well as compliance and governance, those same companies are often unsure about **how to anchor ESG topics in their respective strategy, governance and remuneration practices**. Based on this observation, the question arises as to how your organization can warrant the achievement of strategic ESG goals? Are Board of Directors (Boards) and Executive Management really able to independently form an opinion on ESG topics? And lastly, how can your progress be measured and incentivized?

Methodology applied

HCM International Ltd. (HCM) has conducted an explorative study to analyze the status-quo regarding ESG integration in the banking and insurance industry in Switzerland. To structure the findings, the HCM framework "**4 Action Points for Decision Makers**" was used (see chart below). The analysis focused on **whether and how the top 25 companies in the SPI Financial Index[4] already implement ESG considerations in strategy, governance and remuneration** with a special focus on encountered challenges and envisioned improvements. The quantitative analysis was further supported by personal interviews conducted with selected CEOs and Chairpersons of Swiss financial service companies in order to substantiate publicly available data with insights into actual company practices and processes[5].

1 See e.g. Financial Stability, Financial Services and Capital Markets Union (Jan. 2020). *The European Green Deal Investment Plan and Just Transition Mechanism*.

2 Fink, L. (Jan. 2020). *A Fundamental Reshaping of Finance – BlackRock Letter to CEOs*.

3 For a copy of the survey please contact us.

4 Based on market capitalization as of 31.12.2019 this includes Zurich Insurance, UBS, Swiss Re, Credit Suisse, Partners Group, Swiss Life, Julius Bär, Baloise, Swiss Prime Site, Helvetia, Banque Cantonale Vaudoise, Pargesa, PSP Swiss Property, Vontobel, Luzerner Kantonalbank, Cembra Money Bank, Allreal, St Galler Kantonalbank, VZ Holding, Berner Kantonalbank, Liechtensteinische Landesbank, Mobimo, EFG International, Zuger Kantonalbank and Banque Cantonale du Valais. A more comprehensive review is planned as a next step.

5 We would like to thank all interview participants for their time and commitment, including representatives of the following companies: Basellandschaftliche Kantonalbank, Blue Orchard, Cembra Money Bank, Credit Suisse, Globalance, Graubündner Kantonalbank, Liechten-steinische Landesbank, Postfinance, Raiffeisen Schweiz, Swiss Life, Valiant, VP Bank, Zuger Kantonalbank, Zurich Insurance.

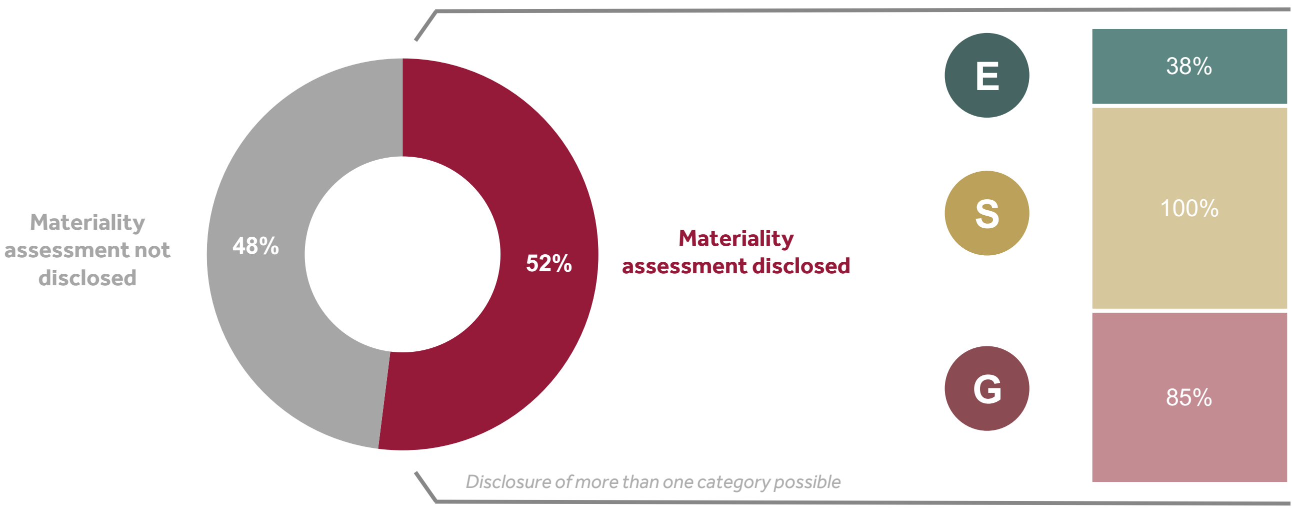
Four key findings on how companies reflect ESG considerations in strategy, governance and remuneration

1. Define your key ESG topics

Similar to the struggle in other industries, one of the key challenges that ESG-related initiatives face in the financial service industry is the **diverse definition of ESG**. In the interviews conducted, these challenges were often perceived to be based on a "lack of ESG code of conducts" or "different level of strictness" in the pursuit of such initiatives in a "very broad topic"[6]. Therefore, defining your organization's key ESG topics by means of a materiality assessment is a helpful step based on the interview feedback received.

Such assessments are based on internal and external stakeholder feedback and vary depending on industry, business model, strategy and culture. For most companies, materiality assessments form a key step towards the definition of focus topics as well as finding a common language. However, of the financial service companies analyzed in this review, **only 52% publish a materiality assessment in which key ESG topics are defined**.

Of the reviewed companies that disclose such an assessment, **all of them pay tribute to social topics such as societally relevant diversity topics**. Governance topics are also rather common with 85%. Contrarily, **environmental topics are assessed as highly material topics by a mere 38%** of companies publishing a materiality assessment and, in general, disclosed with higher frequency by the insurance industry.



Top Environmental Topics	Top Social Topics	Top Governance Topics
1 Climate change	1 Employee training & development	1 Compliance
2 Greenhouse gas emissions	2 Customer satisfaction & data protection	2 Corporate Governance
3 Environmental risk management	3 Diversity & inclusion	3 Ethics

[6] Anonymized interview feedback from interviews conducted with selected CEOs and Chairpersons of Swiss financial service companies.

According to the interviews conducted, the main struggle lies in **understanding what these topics actually mean for your organization**. Topics such as “climate change” or “ethics”, for instance, are highly broad in nature. Which are the key areas to look at? And do these relate **only to your inhouse processes** (e.g. reducing greenhouse gas emissions in your offices or ensuring compliance) **or also to your external products and services** (e.g. disinvestment from CO2-heavy industries or ensuring ethical processes at the companies you are invested in)?

Based on the interview feedback, the **product side is often much further developed than the internal process side**, especially in terms of offering “green financial products” such as green funds or bonds. While banks in Switzerland are not yet required to proactively ask for ESG preferences of their clients, the EU plans on including such questions as a mandatory part of the suitability assessment under MiFID II, which in turn, is **expected to have impact on Swiss regulation as well**[7].

Another observation made by interview participants relates to the fact that ESG topics are often not yet considered for credit rating and risk assessments. What has also not yet become mainstream, is the understanding that **banks and insurance companies can proactively influence the ESG performance of their clients**. While some banks passively wait for borrowers to perform better against social or environmental benchmarks, some of the companies interviewed in this explorative study plan on proactively integrating ESG topics into credit assessments – and drawing consequences based thereon.

- **Only 52%** of the reviewed companies **disclose key ESG topics** with a main focus **on social (100%) and governance (85%)** topics.
- Identifying what these topics mean for your organization not only in terms of **external products and services but also regarding internal processes**, is challenging – but essential for defining your ESG approach.

2. Formulate your strategy and governance

Following the definition of your key ESG topics, the question remains as to how these can effectively be integrated in your strategy? How are strategic initiatives derived therefrom? According to the interviews conducted, financial service companies often struggle to define *where* ESG plays a role internally and externally and **how to derive concrete strategic goals and initiatives** based thereon.

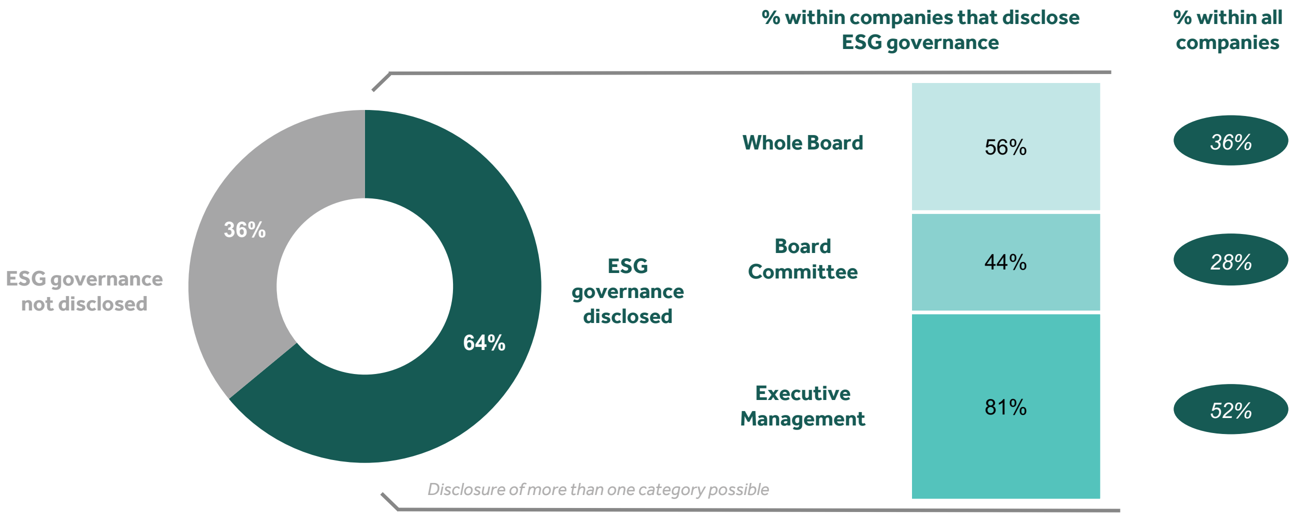
Another observed challenge based on the conducted interviews relates to the **lack of clear governance and strategic decision-making structures around ESG**. Acquiring the right expertise, integrating ESG as part of the strategy cycle, establishing appropriate governance processes and assigning responsibilities are essential next steps to ensure effective management of your ESG topics.

While the definition of a long-term ESG strategy is ideally part of the Board's responsibilities and **discussed with the whole Board, only 36% of the analyzed companies disclose following this practice**. Approximately 28% of the reviewed companies also disclose having a separate Board committee on ESG in place.

[7] See e.g. M. Eckert, T. Teves, S. Fuchs (Feb. 2020). *MME Study: Climate Change – Fiduciary Duties for Financial Service Providers*, retrieved under: https://www.mme.ch/en/magazine/magazine-detail/url_magazine/esg_climate_risks_in_the_financial_industry/

Next to assigning clear responsibilities within the Board, **systematically anchoring ESG topics within the organization still needs improvement**, with only 52% of the companies disclosing active management of ESG topics at the executive level. Chairpersons and CEOs interviewed also supported this overall impression by highlighting that ESG topics are typically discussed somewhere within the organization but are **not yet highly prioritized at the level of the Board and Executive Management** – though positive examples can be found as well.

Based on the interviews conducted with selected CEOs and Chairpersons of Swiss financial service companies, appropriate governance processes are fundamental for **setting the right tone from the top** and increasing credibility, which remains one of the key issues in the area of ESG. In case of insufficiently stringent governance around ESG, how can your decision-makers design appropriate initiatives to implement corporate ESG strategies? How can your ESG goals be cascaded, measured and controlled? How can your employees be engaged on this journey?



- According to the interviews conducted, companies often struggle to define **where ESG plays a role both internally and externally and how to derive concrete strategic goals and initiatives**.
- While the definition of a long-term ESG strategy is ideally part of the Board's responsibilities, **only 36% of the analyzed companies disclose following this practice**. Approximately 28% also disclose having a separate Board committee on ESG in place. Below the Board, **only 52% of the companies disclose active management of ESG topics at the executive level**.
- To ensure the right "tone from the top", ESG should become an **anchored aspect of consideration in your regular strategic cycle** enabling the successful implementation of your ESG initiatives through prioritization and clear communication cascaded throughout the organization.

3. Get your employees on board

Though employees sometimes actively ask for ESG commitments of their employers or initiate own initiatives as is done at some of the interviewed companies, **bringing employees on board largely remains a challenge** in the Swiss financial service industry. Respective ESG training sessions are often perceived as an additional burden and prejudices around ESG prevail.

Often faced with ESG-related feedback from their employees surrounding questions such as "Are we no longer allowed to fly to business meetings?" or "Are we banning meat in our staff restaurant?", organizations increasingly encounter the need to **focus their efforts around the benefits of engaging their employees on the ESG journey**. Arguably, this may also be more well-received, as one of the topics mentioned during our interviews was for instance that client-facing functions welcome the additional benefit of communicating ESG topics to their customers. This is especially true for re-gaining customer trust and winning over millennials and young members of high-net-worth families[8].

In our experience, bringing employees on board at an early stage such as via employee contribution programs, joint workshops or employee surveys is essential to **foster strong organizational support and employee commitment regarding ESG initiatives**. Some of the interviewed companies have realized this potential and are promoting a bottom-up approach. Such an approach, however, needs to be based on sound strategy and governance processes in order to support implementation initiatives and be perceived as a priority by the broad company population.

➡ Employees are often burdened with the more administrative part of ESG implementation, which is coined by prejudices surrounding ESG and makes communication and engagement more difficult.

➡ Engaging employees at an early stage by a **bottom-up approach** and **communicating the expected benefits**, however, is key to realizing your ESG strategy. The same holds true for ensuring that your employees have sufficient resources and capabilities regarding ESG.

4. Hold management accountable

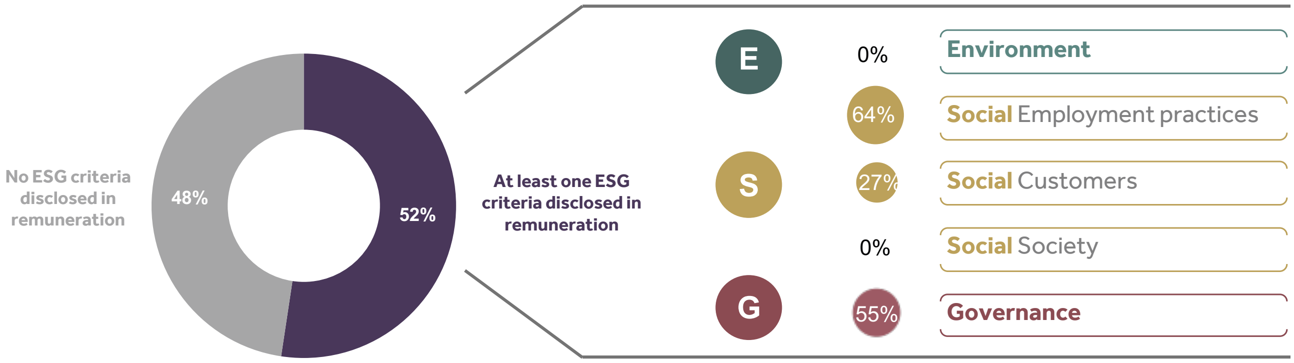
Though accountability regarding ESG is also related to measuring and tracking progress as well as performance management, remuneration is an important aspect to ensure internal and external prioritization as well as foster credibility and trust in ESG-related initiatives. Though the pros and cons of linking these topics to pay are heavily discussed, updated voting guidelines by proxy advisors such as ISS, zRating, Ethos and GlassLewis as well as recent statements by major international investors such as BlackRock increase the pressure on Swiss banks and insurers, especially when it comes to ensuring that ESG efforts are credible beyond being perceived as "a pure marketing exercise"[9].

In Switzerland, **52% of the banks and insurers in the HCM Top 100 Switzerland data set disclose a link of ESG initiatives to variable pay**[10]. In the majority of these instances, companies typically integrate ESG concerns in the short-term variable pay. Regarding the question *where* ESG is integrated, **two fundamental approaches** can be distinguished:

- including ESG as part of the individual scorecard or
- reflecting such topics at the level of the overall bonus pool, i.e. the group or divisional level.

In practice, the reviewed companies apply a variety of combinations though incentivization at the individual level prevails (see illustration next page).

[8] Brown, K., Wood, D., Paetzold, F. (2019). *Impact Investing for the Next Generation: Insights from Young Members of Investor and Business Families*. Cologny/Geneva: World Economic Forum.
[9] Anonymized interview feedback from conducted interviews with selected CEOs and Chairpersons of Swiss financial service companies.
[10] HCM analysis based on HCM Swiss Top 100 financial service industry cluster.



But what ESG topics are typically reflected in remuneration? The analyzed companies focus on social topics: The main ESG category used relates to employment practices (e.g. talent management, behavior and collaboration) as well as customers (e.g. customer focus and satisfaction). Likely owing to regulatory requirements and the fact that the financial service industry is already quite advanced when it comes to governance and compliance issues, the main topic disclosed for the "G" concerns regulatory compliance.

One of the reasons why some companies do not yet make a link between ESG and pay is the **perception of non-existent reliable KPIs**. In our experience, breaking down key ESG topics into **long-term strategic goals supported by concrete and achievable yearly targets** is key to overcoming this challenge. Explicitly relating ESG topics to strategy will facilitate the anchoring and determination of reliable, relevant KPIs.

This brings us to **the biggest challenge around ESG in pay: Measurement**. This is especially important in order to render the impact of ESG initiatives visible and anchor ESG considerations in employee behavior and corporate culture. While organizations have become professional at measuring financial targets, finding reliable figures for environmental or social topics often needs some more data-digging, analysis and training. A few of the companies interviewed mentioned using market indices such as the Dow Jones Sustainability Index, FTSE4Good or MSCI Global Sustainability Indices to ensure an externally benchmarked and reliable source. However, interviewees also acknowledged the problem of such broad ratings that do not necessarily reflect the identified material ESG topics. Though more progress is being done in this area, recent work has shown that allowing for sufficient discretion and Board oversight regarding targets and progress is necessary for such a system to work effectively.

- Investors are increasingly scrutinizing remuneration systems for the reflection of ESG topics as a **proxy to how credible ESG efforts are**.
- **52% of the banks and insurers** in the HCM Top 100 Switzerland data set **disclose a link of ESG initiatives to variable pay** with a focus on including ESG as part of the individual targets.
- **Breaking down your ESG topics into yearly measurable KPIs** is essential for setting the right tone from the top and ensuring appropriate priorities. Clear tracking and reporting also supports your **credibility and reputation**.

What is the conclusion?

Following the structure of the "**HCM 4 Action Points for Decision Makers**" we have identified the following key action steps for financial service providers aiming at a successful implementation of ESG topics in strategy, governance and remuneration processes:

1. **Define your key ESG topics**: Working with clients in the financial sector, we advise to **conduct an ESG Focus Process** where key ESG topics are analyzed. Based on the envisioned ESG positioning, **current gaps** regarding strategy and risk management have to be assessed and **concrete steps towards implementation** have to be defined based on internal and external stakeholder priorities.

2. **Formulate your strategy & governance**: In a second step, an **appropriate ESG Governance Network** is established by ensuring ESG expertise and diversity as well as checks and balances on ESG topics. Establishing adequate governance structures then supports the definition of strategic goals and initiatives as well as prioritization.

3. **Get your employees on board**: Following the **ESG Capability Circle approach**, the design of stakeholder engagement strategies is supported to move from employee understanding to empowerment and to ensure the availability of the "right" capabilities.

4. **Hold management accountable**: ESG topics can then be integrated into the performance management system and remuneration frameworks, ultimately resulting in an **ESG Performance Map that can be used for tracking and reporting** on your ESG progress. Especially establishing a strong link between ESG and remuneration supports your credibility and reputation.

About HCM Services on ESG

HCM provides an independent outside-in view on whether a company is on track and doing the right things (and not just doing things right), whether with regard to environmental and social matters or governance and compliance practices. With nearly two decades of experience in advising both large publicly listed companies and private companies, our deep-rooted expertise and specific focus on governance-related issues enables an understanding of the major strategic challenges that companies face today, including ESG topics. As the chair of the Global Governance and Executive Compensation Group (GECN) we take on a leading position in monitoring global governance related trends and risks.

We work with various stakeholder groups (institutional investors, proxy advisors, rating agencies, regulators, international standard setters, etc.) as well as with owners, Board of Directors, Executive Management and the heads of key functions such as ESG departments, HR, Risk, Compliance and other functions. Our services include:

Supporting decision-makers considering a new ESG strategy or (re-)organization, including strategic assessments and support for devising and implementing effective ESG initiatives based on our proprietary **ESG Focus Process**, often also including an **ESG Gap Analysis**

Aligning with international best practices and developments on ESG topics, including regulatory developments

Designing an **ESG Governance Network** by ensuring appropriate ESG expertise and diversity as well as checks & balances on ESG topics including ESG assessments, trainings and communication

Designing stakeholder engagement strategies, including strategies to reduce internal blockages and get better support for ESG topics from employees, management and Board of Directors following the **ESG Capability Circle** approach

Integrating ESG topics into the performance management system and remuneration frameworks, including design and parametrization of remuneration elements that better capture and reward ESG performance based on market practice and trends, following our proprietary **ESG Performance Map** that includes both internal/externally measured KPIs with a backward- and forward-looking perspective

Should these topics interest you or be of current concern to your company, please do not hesitate to contact us for a non-binding discussion anytime.

About the Authors

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Claudia Würstle has more than seven years of work experience in the areas of strategic consulting, corporate responsibility, governance and compensation. At HCM, Claudia Würstle is focused on topics regarding sustainability and ESG topics in compensation plans and governance, performance analysis as well as the implementation of compensation concepts and performance management in both the financial and industrial sector. She holds a Master's degree from the University of St. Gallen (HSG) and a Bachelor's degree from the EBS University of Business and Law, Oestrich-Winkel, Germany. During her studies, Claudia Würstle focused on sustainability and personnel management. Claudia Würstle is a certified Sustainability Associate by the International Society for Sustainability Professionals (ISSP).

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