



HOSTETTLER & COMPANY
Governance. Risk & Finance. Compensation.

HCM Viewpoint

Pay-for-Sustainability: How to reflect ESG in modern compensation systems

hcm.com

Environmental, Social and Governance (ESG) factors are receiving considerable public attention. Integrating these aspects into compensation systems is an important step for credibly driving your sustainability agenda

Sustainability – yes or no? Though often wrongly mistaken for an empty marketing concept, sustainability has almost become a licence-to-operate for both national and international players. In fact, given the recent developments such as the formulation of the Sustainable Development Goals (SDGs) or the United Nations-backed Principles for Responsible Investing (PRI) there is no escaping any more. Also in Switzerland, the topic is increasingly receiving attention with the Federal Council announcing that sustainability should be included in the concept of fiduciary duty.

Besides governmental agencies and non-profit organizations, investors are also taking action. In fact, it is estimated that around every fifth dollar under professional management is invested following sustainable and responsible strategies with an increasing number of financial institutions introducing sustainability requirements to their investment processes. The impact of investments on, for example, the environmental footprint is increasingly being monitored. Indeed, doing “good” pays off and academic research shows that such strategies result in better risk-adjusted financial performance than traditional ones.¹

In that respect, certain players are making bold moves. For instance, Norway’s USD 960 billion sovereign wealth fund will request the banks, in which it has invested, to disclose how their lending contributes to the reduction of greenhouse gas emissions. In the UK, the Environmental

Audit Committee has requested the 25 biggest pension funds to publicly disclose how they manage climate-change risk of pension savings. In Switzerland, major player Swiss Re recently announced its decision to shift its CHF 120bn investment portfolio to benchmarks that systematically integrate ESG criteria.

But how can ESG strategies be implemented and what are relevant levers?

One answer lies in appropriate compensation systems. If designed and calibrated properly, incentive systems can serve as a catalyst to drive a company’s ESG agenda and support corporate efforts. In 2012, the PRI, an international investors network and leading proponent of responsible investments, published a first guidance on the integration of ESG in executive compensation plans.² Though since then some development has occurred, practical advice on how to link ESG performance to variable pay is still lacking. As an attempt to fill this gap and better structure the discussion around it, HCM has built on the PRI recommendations and developed a 5-step approach on how to integrate ESG considerations in compensation systems.

An increasing number of companies integrate ESG criteria in their executive compensation systems

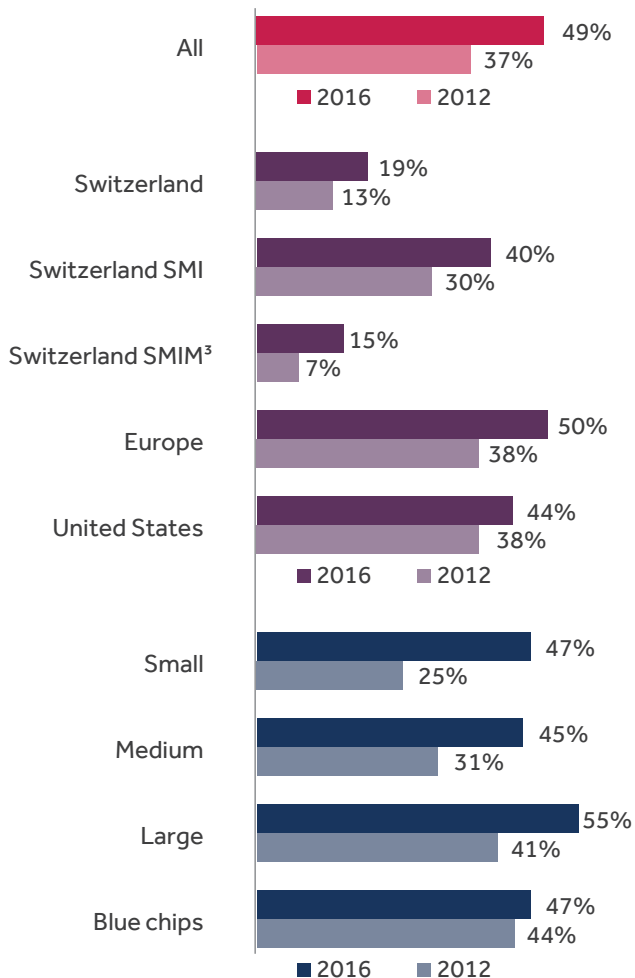
HCM’s research using its proprietary database shows that there is a significant momentum regarding the integration of ESG factors in executive compensation. In fact, the number of companies disclosing specific ESG criteria in how they pay their executives increased from one third to one half from 2012 to 2016 (see figure 1). Switzerland is, however, slightly lagging behind with only 40 percent of the companies in the blue chip Swiss market index (SMI) disclosing such links.

¹ See, for example, Friede, G., Busch, T. & Bassen, A. (2015). ESG and financial performance: Aggregated evidence from more than 2000 empirical studies. *Journal of Sustainable Finance & Investment*, 5(4), 201-233; or Serafeim, G. and Calvert Investments (2017). *The Financial and Societal Benefits of ESG Integration: Focus on materiality*, or the meta study conducted by Orlitzky, M., Schmidt, F. L., & Rynes, S. L. (2003). *Corporate social and financial performance: A meta-analysis*. *Organization Studies*, 24: 403-441.

² All references to the PRI principles in the text refer to PRI (2012). *Integrating ESG issues into executive pay – Guidance for investors and companies*, and PRI (2016). *Integrating ESG issues into executive pay – A review of global utility and extractive companies*.

HCM's 5-step approach structures discussions and supports decision-making

Figure 1: Analysis of Swiss and global companies disclosing a link between ESG factors and executive pay

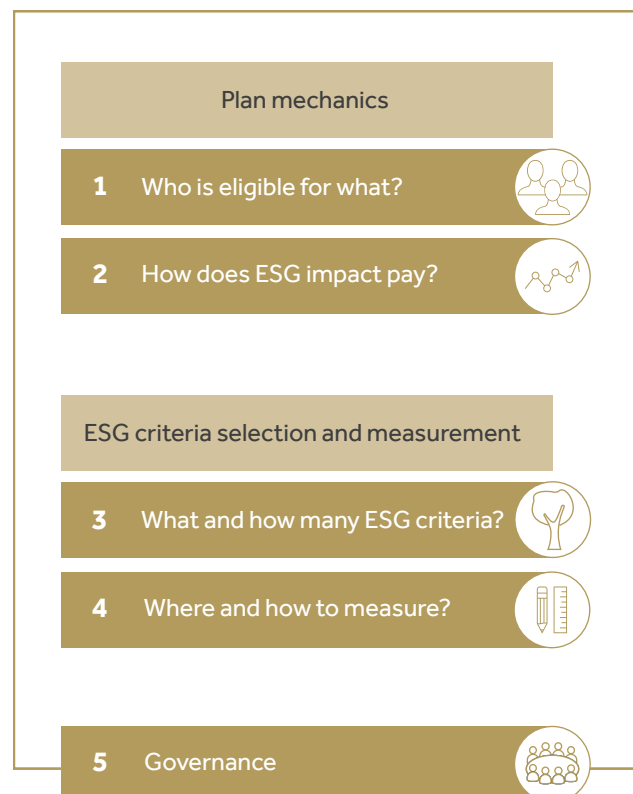


Source: HCM database based on publicly available data

One important aspect to keep in mind is that company size⁴ correlates to a large extent with the considerations given to sustainability performance. In our global sample, this is partially reflected as only global companies of a certain size are represented.⁵ For Switzerland, the depth of the database provides more thorough evidence of the size effects: While 40 percent of the SMI companies disclosed sustainability criteria, only 15 percent of the SMIM companies did so.⁶ Market practice on how these companies integrate ESG in compensation, however, is diverging.

Building on the PRI recommendations, HCM developed its own approach to reflect ESG in compensation systems to structure discussions and support decision-making on key design aspects. This approach consists in five distinctive steps as shown in figure 2. The first step addresses participants' eligibility to compensation plans. Secondly, the mechanics of how ESG factors impact compensation need to be outlined. Thirdly, ESG performance indicators can be selected with the key aspects to consider being the *type* and *number* of ESG criteria. Next, the *level* and way to measure ESG performance is to be addressed. Finally, a robust *governance structure* around ESG-related compensation decisions needs to be put in place.

Figure 2: HCM 5-step approach to integrate ESG in compensation systems



³ The SMIM includes the 30 largest mid-cap stocks in the Swiss market that are not included in the blue chip SMI index.

⁴ Size is proxied by market capitalization. Four groups were formed with regard to size: small-sized with a market capitalization of CHF 15 billion or less, mid-sized with a market capitalization between CHF 15 and 30 billion, large-sized with a market capitalization between CHF 30 and 70 billion, and blue chip firms with a market capitalization of more than CHF 70 billion.

⁵ The smallest company, as proxied by market capitalization, in the sample had a market capitalization of CHF 7.55 billion as of 31.12.2016.

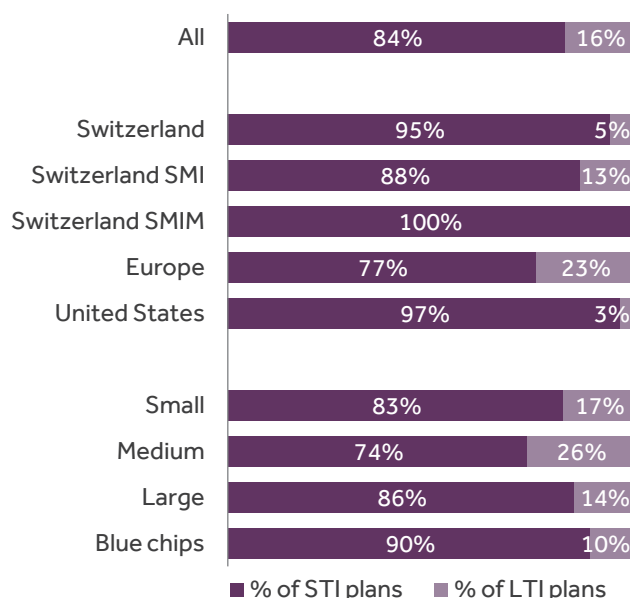
⁶ Note that Swiss SMIM mid-cap and smaller mid-cap companies are not included in our global sample.

Step 1: Who is eligible for what?

In general, the question of *who is eligible for what* is typically a trade-off between raising accountability and awareness of ESG topics inside the organization on the one hand and increasing complexity on the other hand. The PRI recommendations put forward the need for adequate links to sustainability topics at various employee levels. In our experience, the senior leadership team (typically about 2-3 percent of the employee population) has the largest influence on strategy and the attention given to ESG topics. Therefore they are the most critical ones to get on board and incentivize accordingly. After an appropriate tone from the top is embedded, compensation systems can subsequently be rolled out to include further employee levels.

The next question to ask is *what* exactly is this employee eligible for. While it may make sense to create specific awards relating to ESG performance, the risk of over-complicating plans should not be underestimated. Introducing new compensation plans or on-top awards depends on the design and complexity of the current system but, as a general rule, as long as the existing compensation system allows it, embedding such criteria in the status quo is less difficult to communicate.

Figure 3: Prevalence of ESG criteria disclosed in STI/LTI plans



Source: HCM database based on publicly available data

In that respect, sustainability topics can be reflected in both short-term incentive (STI) and/or long-term incentive (LTI) plans. As ESG considerations are typically expected to create value over the long-term, one might intuitively think about integrating them in long-term plans. Market practice actually goes in the other direction. ESG criteria are integrated in STI plans in over 80 percent of the cases (see figure 3). In the US, this observation is even more striking with only 3 percent of the analyzed companies disclosing the integration of ESG criteria in LTI plans. One potential explanation is the need to break down long-term goals into reachable yearly targets and incentivize accordingly.

Step 2: How does ESG impact pay?

The second step towards integrating ESG in compensation plans is the fundamental decision regarding the *type* of impact. Here, two schools of thoughts can be distinguished. For some, ESG criteria such as the reduction of carbon emissions or customer satisfaction cannot and should not be maximized per se and as a consequence should rather be integrated as boundary conditions that need to be fulfilled in order to receive any variable compensation (so-called “thresholds conditions”). In other words, non-achievement leads to a downward adjustment of variable pay.

The other school of thought advocates a reward-approach, meaning that variable pay can also be increased depending on ESG performance. This approach supports the notion of value creation via better ESG performance. For instance, increasing the market share of “green” products leads to higher revenue and potentially higher profits which companies may reward with higher variable compensation. Companies that rely on ESG topics as part of their business models, such as solar panel providers or sustainable mobility developers, usually have this approach already reflected in their business performance and (directly or indirectly) in their variable pay. In practice, a combination of the two approaches is also possible – depending on the indicator used.

Important to keep in mind, however, are potential incentive conflicts, either between traditional key

performance indicators (KPIs) and ESG-related KPIs or between ESG-related KPIs themselves. In that respect, decision makers need to decide on the kind of behavior and performance to incentivize and pay close attention to potential conflicts.

Step 3: What and how many ESG criteria?

In terms of *what* ESG criteria to use for compensation purposes, let's have a look at current market practice. For this purpose, HCM developed its own classification of ESG indicators built on the standards of the Global Reporting Initiative (GRI), one of the major standard-setters for reporting on sustainability (see figure 4).⁷ These criteria were then used to review executive compensation within the HCM database.

Clearly, criteria relating to social aspects, and predominantly to employment practices, were the most widely used in compensation plans with 27 percent of companies reporting the use of at least one such criteria (see top row in figure 5). The second largest cluster is – still in the social category – KPIs relating to customers (16 percent) followed by general sustainability indicators (14 percent) and environmental criteria (9 percent).

Looking at regional differences, general indicators such as the performance in relation to ESG indices or overall sustainability efforts are much more common in Europe (21 percent) than in the US or Switzerland, whereas social aspects including customer satisfaction are used more often in the US.

The main differences in KPIs used, however, can be seen when comparing various industries. For instance, the oil & gas industry predominantly uses environment- and employment-related indicators (both 85 percent) such as the reduction of burned gas as a by-product or the increase health and safety efforts. In contrast, financial companies focus on social aspects such as diversity and customer satisfaction. In the consumer services and industrials sector, criteria relating to the overall sustainability performance are preferred (24 and 20 percent, respectively).

Despite differences based on the industry, decision-makers need to remain cautious when selecting ESG criteria which also depend, among others, on the specific situation, business model, lifecycle and overall ESG strategy. As also advocated by the PRI principles, companies need to ensure consistency between the

Figure 4: Classification of KPIs for compensation purposes with some typical examples of KPIs

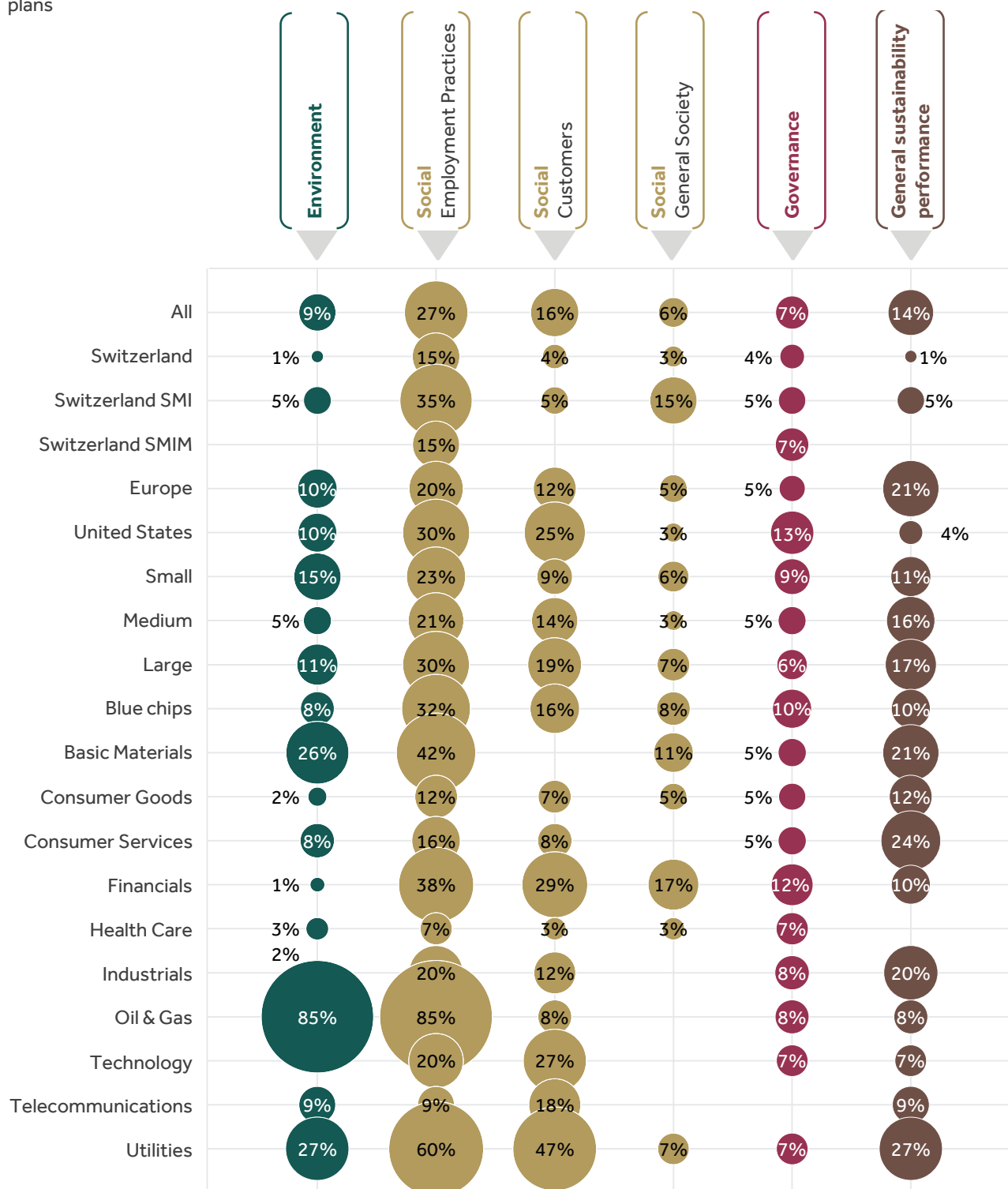
	Environmental	Social			Governance
		Employment Practices	Customers	General Society	
Examples of KPIs	- Volume of operational spills - Environmental responsibility - Reduction of CO₂ emissions - Green product development	- Workforce diversity - Process safety - Talent management - Employee satisfaction	- Customer satisfaction - Customer focus/centricity - Safety performance	- Human rights topics - Social value creation - Involvement in social projects - Community engagement	- Compliance - Risk culture - Fulfilment of governance/compliance policies
General Sustainability Performance					
- Overall sustainability ambitions - Corporate responsibility - Sustainability index ratings - Sustainable product launch					

Source: HCM, adapted from the standards of the Global Reporting Initiative (GRI)

⁷ According to the GRI, 74 percent of the world's largest 250 companies report on sustainability performance using the GRI standards. Global Reporting Initiative: *GRI and Sustainability Reporting*.

Figure 5: Overview of ESG indicators disclosed clustered by region, size and industry

The size of the bubble corresponds to the frequency of the respective criteria disclosed for executive compensation plans



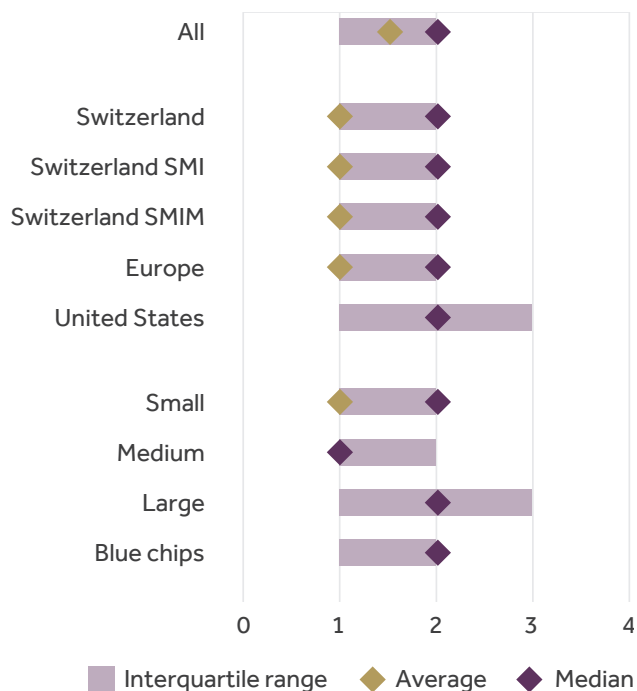
Source: HCM database based on publicly available data

issues reported on sustainability reports or identified via materiality assessments and compensation systems. Moreover, the selection process of ESG criteria needs to be explained carefully and should consider inputs from stakeholders to ensure the inclusion of relevant and meaningful KPIs.

Together with the question of *which* KPIs to use for compensation purposes, the question of *how many* KPIs needs to be addressed. In-line with the PRI principles referring to a select number of indicators, market practice shows that – independent of the industry – typically one to two KPIs relating to ESG are used in STI plans (see figure 6).

For LTI plans, all observed companies used one KPI.

Figure 6: Number of ESG KPIs used in STI plans per company



Source: HCM database based on publicly available data

Step 4: Where and how to measure?

One of the main issues of sustainability is the perceived lack of reliable and objective measurement approaches. In fact, ESG performance is not easy to quantify on all organizational levels since the causal chain is less obvious than with traditional financial relationships that have been studied for decades. Therefore, *measurement* becomes a crucial success factor for ESG criteria in compensation systems.

Taking CO₂ emissions, community involvement or compliance as examples, ESG efforts typically involve a rather large group of employees in order to achieve a tangible impact. If only individual performance is measured, serious incentive conflicts could arise. In fact, when deciding *where* to measure, companies are well-advised to take a higher level than one might initially think. Therefore, modern compensation systems measure performance rather for extended teams, divisions or the whole company. This approach not only avoids conflicts but also supports the development of a collaborative culture.

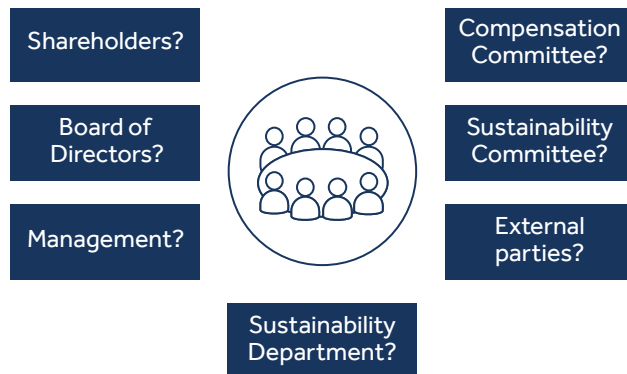
Next to the level of measurement, also the *type of measurement* needs to be defined. While in the previous phases of industrialization, employees often performed clearly distinguishable and rather repetitive tasks that could be monitored and clearly measured, today's agile work environment based on team work and collaboration make such distinctions impossible. So rather than trying to measure the exact ESG impact for each and every position, a holistic assessment is often more practicable and in fact provides a better picture of actual ESG performance.

Step 5: Governance

The final step in designing an ESG-linked compensation system is the set-up of the *right governance* around it. While different bodies can be involved in assessing ESG performance (see figure 7), the authority typically lies with the Board of Directors, at least when it comes to the impact on executive compensation, supported by inputs from other committees or experts in charge of ESG-related topics.

The reflection of ESG criteria in compensation is increasingly common but more effort is necessary to provide a credible “tone from the top”

Figure 7: Common ESG-related input and decision-making bodies



One significant trend regarding the governance of ESG is the increasing existence of sustainability committees (see figure 8): In fact, one third of the analysed companies have a committee at the board level in charge of sustainability topics with bigger companies being even more likely to do so. This might be a consequence of the increased external and internal pressure, but it certainly also has to do with the complexity and importance of the topic in larger companies. With 40 percent of the SMI companies having in place a committee that deals with ESG topics (either as a stand-alone committee or in combination with other topics such as nomination, audit or compliance), larger Swiss companies are ahead of smaller Swiss firms (11 percent).

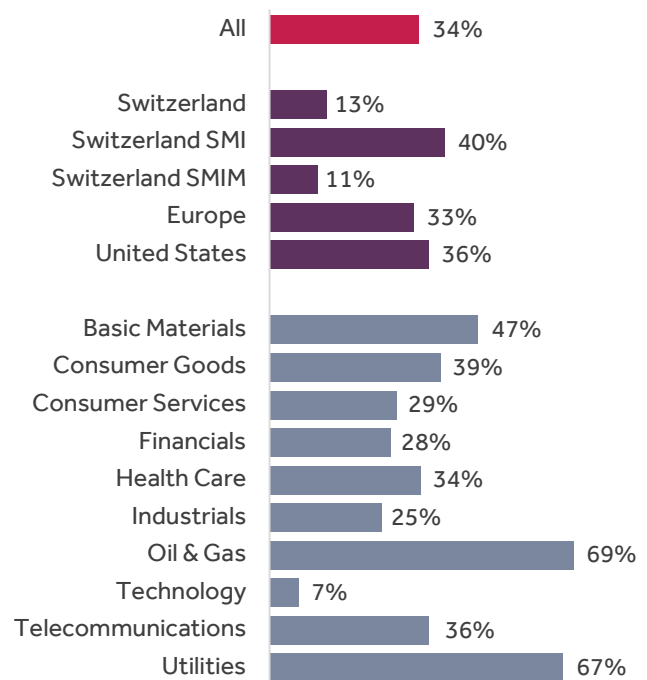
Next to regional differences, also significant differences between industries can be observed. Again, the oil & gas and utilities industries are at the forefront with almost 70 percent having established committees for sustainability topics. In contrast, only 7 percent of the companies in the technology industry have such a committee while the remaining industries are more or less distributed between 25 and 45 percent.

Besides feedback on strategic topics, such committees can also provide the necessary know-how and experience in the context of evaluating ESG performance. This, however, should not discharge the Board of Directors from direct access to reliable and independent information regarding sustainability performance in line with good governance practices.

Recent international developments show that ESG topics are increasingly important for influencers, investors (public and private), employees and other stakeholders. To further support a company's efforts towards ESG, the key success factor usually lies in a clear commitment from the highest levels of the organization and a successful integration of ESG topics in the day-to-day operations. On that basis, considering ESG performance in compensation decisions serves as an important catalyst. If designed and calibrated properly, such systems can support sustainable business models and long-term success.

In that respect, positive changes can be observed with an increasing number of companies having ESG performance criteria influencing executive pay. However, room for improvement remains, which may also be due to the lack of a structured discussion around such efforts. With our 5-step approach, we provide a systematic logic that helps companies integrating ESG criteria in compensation systems as well as external stakeholders in assessing such systems.

Figure 8: Companies with an ESG committee at the level of the Board of Directors



Source: HCM database based on publicly available data

About the authors



stephan.hostettler@hcm.com

Dr. Stephan Hostettler **Managing Partner**

Dr. Stephan Hostettler is the founder and managing partner of HCM International and has been active as an entrepreneur and consultant in Switzerland, the US, Europe and other regions since 2002. Prior to this, he worked for a major Swiss bank in the area of financial analysis and as a consultant on corporate finance and corporate governance in the US.

His teaching activities at the University of St. Gallen, his research as well as publications and commentaries have made him an expert and thought leader in the topics of corporate governance, value-based management and executive compensation. As part of his consultancy practice, he has advised more than 350 companies. Stephan Hostettler has also become a renowned guest speaker at various conferences, including the TED Talks. He holds a doctorate degree in finance from the University of St. Gallen and is the author of several books.



raphael.lambin@hcm.com

Raphaël Lambin, CFA **Senior Consultant**

Raphaël Lambin combines over eight years of professional experience in the fields of executive compensation, corporate governance and corporate finance. Raphaël primarily focuses on the design and implementation of compensation schemes for senior executives and board members in listed and private companies. Before joining the team, Raphaël worked for a Private Equity house where he was in charge of sourcing and analyzing investment opportunities in various sectors. Raphaël is a CFA Charterholder and holds a Master of Science in Finance from the universities of Lausanne, Geneva and Neuchâtel and a Bachelor in Business Administration from HEC Montreal (Canada).



claudia.wuerstle@hcm.com

Claudia Wuerstle, ISSP Sustainability Associate **Consultant**

Claudia Wuerstle has more than five years of practical experience in the areas of compensation, sustainability and strategy consulting. At HCM, Claudia is focused on topics regarding sustainability in compensation plans and governance, performance analysis as well as the design and implementation of compensation and performance management systems in both the financial and industrial sector. She holds a Master degree from the University of St. Gallen (HSG) and a Bachelor degree from the EBS University of Business and Law, Oestrich-Winkel, Germany. During her studies, she focused on personnel management and sustainable business models. Claudia Wuerstle is a certified Sustainability Associate by the International Society for Sustainability Professionals (ISSP).

Published in May 2018

About HCM International

HCM International Ltd. (HCM) is a leading independent international advisory firm specializing in the strategic aspects of Governance, Compliance, Finance, and Compensation, with deep experience across various industries and in the advising of boards, board committees, senior management, and control functions.

HCM's partners, managers, and analysts work in its offices in Zurich, Geneva, and Kiev. They are bolstered by our global partners in the US, UK, France, Australia, Singapore, and China, which allow us to reach major markets and support companies of all sizes, from large multinationals and public institutions to mid-sized and smaller companies, including those preparing for an IPO.

Our mission is to support companies and other organizations tackle the ever important question: "How to measure, steer and allocate value creation?" We also cover governance, risk and compliance as these also affect value. The "value question" is of core interest not only to Owners, Board of Directors and Senior Management but also increasingly to institutional investors, proxy advisors, HR and control functions, regulators, and international standard setters.

HCM is Chair of the Global Governance and Executive Compensation Group.

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



Swiss Offices

Zurich

Muehlebachstrasse 23/25
CH-8008 Zurich
Phone +41 44 560 33 33
international@hcm.com

Geneva

8 rue des Charmilles
CH-1203 Geneva
Phone +41 22 339 88 50
geneva@hcm.com

HCM International Ltd. Phone: +41 44 450 33 33
Muehlebachstrasse 23/25 contact@hcm.com
CH-8008 Zurich hcm.com

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