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Taking the long view

How should remuneration committees incorporate environmental, social and governance issues into executive pay awards? Neil Hodge reports.

Investors are increasingly pressuring companies to pay greater heed to long-term environmental, social and governance (ESG) issues when they set executive pay, but as there is as yet no universally agreed guidance or standard on how to link ESG metrics to such awards, it can be difficult for some remuneration committees to live up to investor expectations.

Last year, Principles for Responsible Investment (PRI), a UN-supported initiative that promotes the implications of long-term sustainability for investors to incorporate into their investment decision-making and ownership practices, released a report called "Integrating ESG issues into executive pay: A review of global utility and extractive companies". It found that 83% of the 84 organisations surveyed incorporated some type of ESG issue into compensation decisions.

Not so rosy

But this rosy picture darkened as the research further showed that while almost all of the companies incorporated ESG issues in short-term compensation plans, only 16% linked these issues to long-term incentives. Furthermore, the study revealed that the performance metrics used are often obscure, ill defined, or simply fail to capture a company's most critical ESG challenges.

Fiona Reynolds, Managing Director at PRI, says that while a universally agreed standard may take time to develop, she adds that there is an expectation from investors for fuller and better disclosure surrounding executive pay and how remuneration packages are put together.

"Much of the existing complication around executive remuneration schemes has been due to corporations seeking to avoid the high headline remuneration figures behind complicated share and option awards, at times accompanied by vesting processes which are not readily understood by investors," says Reynolds.

"Irrespective of ESG questions, simplifying remuneration and share award features and extending the period over which they operate is now being adopted by some leading companies and should be encouraged," she adds.

Yet remuneration experts say that typical executive reward schemes are still overwhelmingly based on traditional financial targets, such as profit margins, turnover and share price.

Samantha Gee, Client Director at remuneration specialists Innecto Reward Consulting, says that “it remains the case that it is easier to link pay to financial metrics, such as turnover, profit margins, and share price. However, long-term non-financial metrics are increasingly common and expected, and their impact is getting greater.”

Different metrics

In the extractive industry, for example, occupational health and safety (OHS) is often identified as a key ESG metric. More widely, it is clear that efforts to measure and reduce carbon emissions, water and energy usage, and environmentally damaging by-products are becoming more mainstream. Taking responsibility for the activities along the corporate supply chain is also gaining prominence.

Other non-financial metrics are also becoming more widely used, and can be adopted by most organisations, says Gee. “For example, customer satisfaction records, employee diversity, and staff turnover and retention rates are all areas that point to how well an organisation is run, and how strongly the ‘tone at the top’ is communicated throughout the business.”

“Other indicators - such as the number of regulatory fines or legal actions - also give investors a fuller picture of corporate governance, and how seriously the board takes the issue. Shareholders expect greater disclosure on these matters, and boards will need to act accordingly by linking them to pay awards,” says Gee.

Reynolds agrees. “While there may be differing views among investors and other stakeholders, transparent disclosure as part of an open engagement with investors is generally recognised as a sound basis for achieving a balance between the legitimate expectations of senior management on the value of their remuneration and the expectations of investors on how remuneration and reward should be determined given their interest as the ultimate asset owner,” she says.

Neil Hodge

Neil Hodge is a business journalist who writes regularly for “Financial Director”, as well as writing for national newspapers and other finance-related magazines on topics such as risk management, corporate governance, private equity, accountancy and audit.

Non-Executive Directors Group, February 2015

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