February 20, 2020

ESG Metrics and Compensation

Investors, regulators, and companies have become increasingly focused on environmental, social and governance ("ESG") issues, with the recent release by the World Economic Forum of a Consultation Draft of common ESG metrics for investor communications highlighting the growing pressure for disclosure of ESG metrics. As the ESG movement continues to gain momentum, companies are grappling with the relationship between ESG and compensation, with focus both on various prominent ESG factors that relate to human capital and on utilization of ESG goals in incentive compensation design.

ESG Human Capital Factors. Several frequently cited ESG factors relate to compensation or to human capital more generally. The World Economic Forum discussion of common metrics identifies "People" as one of four core areas, including within that rubric standards related to gender pay equality, diversity and inclusion, wage level, and various worker safety and training metrics. Individual companies will grapple with each metric uniquely, but the trend towards a common set of factors reflects an emerging consensus that a successful human capital framework that values employee welfare will improve productivity, motivation, and morale, ultimately resulting in better outcomes for all stakeholders and contributing to long-term profitability.

ESG Incentive Compensation Metrics. According to a recent Willis Towers Watson study, 51% of S&P 500 companies already incorporate ESG-related metrics in their incentive programs, although such metrics are often included within qualitative or individual performance components of the programs and are frequently of limited weight. We expect the prevalence of ESG measures to grow in the years to come. Any attempt to implement ESG goals must begin with an assessment of which ESG issues are most relevant to the individual company and an evaluation of whether all constituents will likely be in directional agreement as to appropriate goals. The largest challenge for many companies will be devising objective criteria for measurement, although movement towards disclosure of common metrics may facilitate establishment of such criteria by standardizing measurements and making peer data more readily available. While, historically, ESG goals have been employed primarily in annual bonus programs, the necessarily long-term view appropriate to sustainability may potentially make them suitable for long-term incentive programs.

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As investors continue to deeply engage in ESG issues, companies should monitor developments and prepare for more widespread use of ESG metrics in compensation programs. With the continued emergence of ESG standards, companies will need to be positioned to educate all constituencies regarding the relevance of ESG issues and how the achievement of related goals will benefit not only executives in their compensation packages but all stakeholders.

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