Linking ESG to Remuneration – Part II

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Introduction

One of the hottest topics across stakeholder groups for ASX listed companies in 2024 is ESG ("environmental, social and governance"), which is attracting a lot of attention in board rooms, annual general meetings and in remuneration committee meetings. In this article, we explore why this is the case, if and how ESG should be linked to remuneration, alongside market data/evidence based on ASX 300 practices, and the scrutiny being applied to this area as regulators rout out "greenwashing".

Why is ESG a hot topic?

The reasons why ESG is a current hot topic will vary depending on who you talk to. However, the most significant reasons cited are outlined below:

1. **Customer and community demands:**
   a) The underlying activities of companies in pursuing profit have never been so visible.
   b) Governments and voters are more engaged than ever with issues of sustainability, ethics and fairness across the economy.
   c) Companies that breach social expectations often face quantifiable financial loss, community, customer and/or government action, and other repercussions.
2. **Modern management and strategy includes it:**
   a) Strategic thinkers recognise that managing business risk cannot be limited to financial considerations, but also the sustainability of environmental impacts and social impacts.
   b) Managing non-financial risk and value can add to or protect financial value.
   c) Competitive advantages can be obtained by better managing non-financial value.
3. **Shareholders and proxy advisors bring focus to it:**
   a) Investment portfolios based on "ethical", "climate friendly" and "ESG" investments are among the fastest growing across global markets. These have often outperformed more traditional portfolios in recent years.
   b) Large institutional investors are increasingly setting out ESG standards they expect companies in which they hold significant positions to adhere to, or risk major selling down of their stock.
   c) Proxy advisor reports include an ESG assessment as standard in most cases.
4. **Regulators are forcing the issue:**
   a) Australian Sustainability Reporting Standards: the first tranche of regulated sustainability reporting requirements (climate-related disclosures) derived from the ISSB/IFRS (the international accounting standards/body for sustainability reporting) will soon apply to Australian company disclosures. This will require discussion of links between KMP remuneration and climate-related risk.
   b) APRA: CPS/CPG 511 require financial entities to explicitly manage, and link reward to non-financial risk management and sustainability.
   c) ASX Listing Rules: the ASX Corporate Governance Council's Principles and Recommendations have long required listed companies to consider climate, sustainability and non-financial risk.

Market Prevalence Overview

GRG undertook additional research into the disclosures of ASX 300 companies that self-identified as having "ESG" metrics as part of short term variable remuneration (short term incentive, STI or STVR) or long term variable remuneration (long term incentive, LTI or LTVR). Results below are based on GRG's 2024 Variable Remuneration Guide:

Sector	Companies with ESG STVR	Companies in the ASX 300	Companies with ESG STVR as a % of ASX 300
Financials	28	65	43%
Industrial & Services	49	145	34%
Resources	40	70	57%
Total	**117**	**280**	**42%**

Sector	Companies with ESG LTVR	Companies in the ASX 300	Companies with ESG LTVR as a % of ASX 300
Financials	2	65	3%
Industrial & Services	7	145	5%
Resources	9	70	13%
Total	**18**	**280**	**6%**

STVR/STI

The following summarises the market data research for STVR (count of metric frequency, the same company may have multiple entries):

Sector	ESG Category	ESG Sub-category	Frequency
Financials	**Compliance**	Regulatory	1
	Environmental	Climate/carbon	10
		Environmental	1
	Governance	ESG policy/Strategy development	7
		Risk management	9
	HR	Culture/Values/Engagement	2
		Diversity/Inclusion	2
	Unspecified ESG Objective		1
Financials Total			**33**
Industrial & Services	**Compliance**	Regulatory	1
	Environmental	Climate/carbon	27
		Environmental	8
	Governance	ESG policy/Strategy development	17
		Risk management	2
	HR	Culture/Values/Engagement	4
		Diversity/Inclusion	7
		Safety	19
	Social	Supply chain/modern slavery	1
		Community impact measures	1
	Other	Customer Satisfaction	1
	Unspecified ESG Objective		1
Industrial & Services Total			**89**
Resources	**Compliance**	Environmental	3
		Impacted community management	1
		Regulatory	1
	Environmental	Climate/carbon	20
		Water Management	3
		Waste reduction	1
		Environmental	7
	Governance	ESG policy/Strategy development	8
	HR	Culture/Values/Engagement	2
		Leadership, Learning and Development	1
		Diversity/Inclusion	6
		Safety	14
	Social	Community impact measures	2
Resources Total			**69**
Grand Total			**191**

LTVR/LTI

The following summarises the market data research relevant to LTVR (count of metric frequency, the same company may have multiple entries):

Sector	ESG Category	ESG Sub-category	Frequency
Financials	Certification	Improved environmental certifications	1
	Environmental	Climate/carbon	1
		Waste reduction	1
	HR	Leadership, Learning and Development	1
		Diversity/Inclusion	3
Financials Total			**7**
Industrial & Services	Diversified ESG	ESG/sustainability report - Compliant, assured	1
	Environmental	Climate/carbon	2
	Governance	ESG policy/Strategy development	2
	HR	Safety	1
	Unspecified ESG Objective		1
Industrial & Services Total			**7**
Resources	Compliance	Environmental	1
	Environmental	Climate/carbon	4
	Governance	ESG policy/Strategy development	2
	HR	Culture/Values/Engagement	2
		Safety	2
Resources Total			**11**
Grand Total			**25**

Key Observations

Several notable observations can be made from the market data presented in this Insight:

1. ESG metrics are significantly more common in STVR structures than in LTVR structures. STVR metrics tend to be subject to lesser scrutiny and rigidity, covering a wider range of types of outcomes, while LTVR tends to be focused, highly scrutinised, and subjected to more rigid views regarding acceptable approaches.
2. Many of these "ESG" factors are not new and would previously have been considered "soft metrics", HR management, hygiene factors, or part of a balanced scorecard. Metrics like employee culture/values and customer satisfaction have been popular candidates for executive STVR for many years, often poorly regarded or rejected, but appear to be being rebranded as "ESG" in some cases (employee engagement and values falls into this bucket but is included in this research where self-declared as ESG). Similarly, safety has long been a controversial metric, with many arguing that it should not be the subject of additional reward, and should instead be a minimum gate; it is appearing again in the guise of ESG, alongside the avoidance of environmental and regulatory breaches. These types of metrics are arguably not true ESG value metrics, as they tend to relate to failures in management (or the avoidance of such) rather than being indicators of success or value creation in the environmental or social domains.
3. Some clear trends have emerged:
    a. Overall, across all sectors, climate/carbon reduction objectives appear to be the strongest represented variable remuneration metrics in the ESG space, likely because they are clear, quantifiable objectives that are relatively easy to track and are readily accepted as both necessary and adding value to the environment and to society. Beyond this:
        i. The resources sector appears to be leading the charge in terms of ESG metric volume, but appears focused on environmental compliance and safety, which are arguably minimum operating requirements.
        ii. Both the Industrial and Services sector and the Financial sector appear to be focused on diversity, again likely because it is quantifiable (note: this research has not captured the risk modifiers/multipliers that can often apply to award calculations in the financial sector; only stated metrics can be assessed).
    b. There are surprisingly few companies linking KMP remuneration directly to sustainability reporting and outcomes therein, despite the rapid increase in companies undertaking

sustainability reporting. Even fewer companies are linking remuneration to recognised standards of reporting with assurance.

4. Many attempts at including non-financial metrics in executive reward have faced significant push-back from shareholders over the years, and ESG metrics have similarly faced mixed responses from stakeholders consistent with this history. However, responses to attempts to include these types of metrics vary significantly by industry, and by the specific kind of metric being introduced.

It should be noted that regulators, including ASIC, are also now putting pressure on companies to ensure that green, ESG and sustainability claims are genuine, and not used to mislead shareholders, customers or the community. This is driving additional scrutiny around the use of ESG metrics in performance pay.

GRG's Advice (for most)

Linking ESG to remuneration is clearly on the agenda for many stakeholders and is not going away. GRG advocates the use of ESG and non-financial value/risk metrics when:

a) the company has a significant environmental and/or social impact that needs to be managed, and/or
b) the company takes ESG matters seriously and genuinely integrates this thinking into its strategy, or
c) it is required by regulators.

GRG's advice is that the best way to link remuneration to ESG, sustainability and non-financial risk metrics is to engage in sustainability reporting; this requires the development of systems and processes to map, track, forecast and report on environmental and social outcomes. When well-recognised sustainability reporting standards (e.g. Global Reporting Initiative or GRI) are adhered to and are the subject of "assurance" (the ESG equivalent of audit), the usual requirements for linking performance outcomes to remuneration will be met, objectives can be clearly articulated, measured, forecasted and linked to both the company strategy and to financial risk/value outcomes.

Where ESG reporting and strategy identifies areas of clear opportunity for value creation ("triple bottom line" value creation, not just financial value creation) then associated measures will be good candidates as performance metrics driving executive reward, and meeting market expectations regarding rigour.

However, where the approach to ESG management, strategy and reporting is less developed, and one or two clear value-driving metrics do not stand out in the strategy, the best approach will be to develop an "ESG balanced scorecard" such as is often used for general staff bonuses, and either:

a) use the outcome of the ESG scorecard as a discrete metric, weighted among other more traditional metrics, noting that this may be viewed by some stakeholders as effectively discretionary if not linked to transparent reporting on scorecard metrics or an assured sustainability report, or
b) use the outcome of the ESG scorecard as a gate or modifier, turning off or scaling the rewards flowing from the outcomes of other, accepted metrics (usually downward).

Both of these approaches should face lesser criticism than trying to include many discrete, weighted metrics related to ESG that may be considered "wishy washy", since they result in minor or no up-side-pay. Due to the requirements of the Banking Executive Accountability Regime, the Financial Accountability Regime, CPS 511 and CPG 511, specialised approaches need to be taken when linking remuneration to non-financial risk and ESG in the financial sector.

Conclusion

Links between KMP remuneration and ESG are likely to be the focus of stakeholder and proxy advisor interest in the remuneration space for years to come. While strong trends in using metrics that are well accepted, and genuinely drive value creation in the ESG space are yet to be settled upon, action is needed and there are clear pathways forward that any company can consider, adopt, and start the journey with. It is also clear that to address these matters properly requires serious investment in analysis and reporting. GRG's associates can assist any company to start developing technology assisted, smart systems to do so. GRG can assist with designing variable remuneration plans, non-financial value, risk or ESG remuneration links, tailored to your business and stakeholder expectations.