ESG VIEWPOINT

Should 'doing good' pay out?
Linking executive pay to ESG metrics

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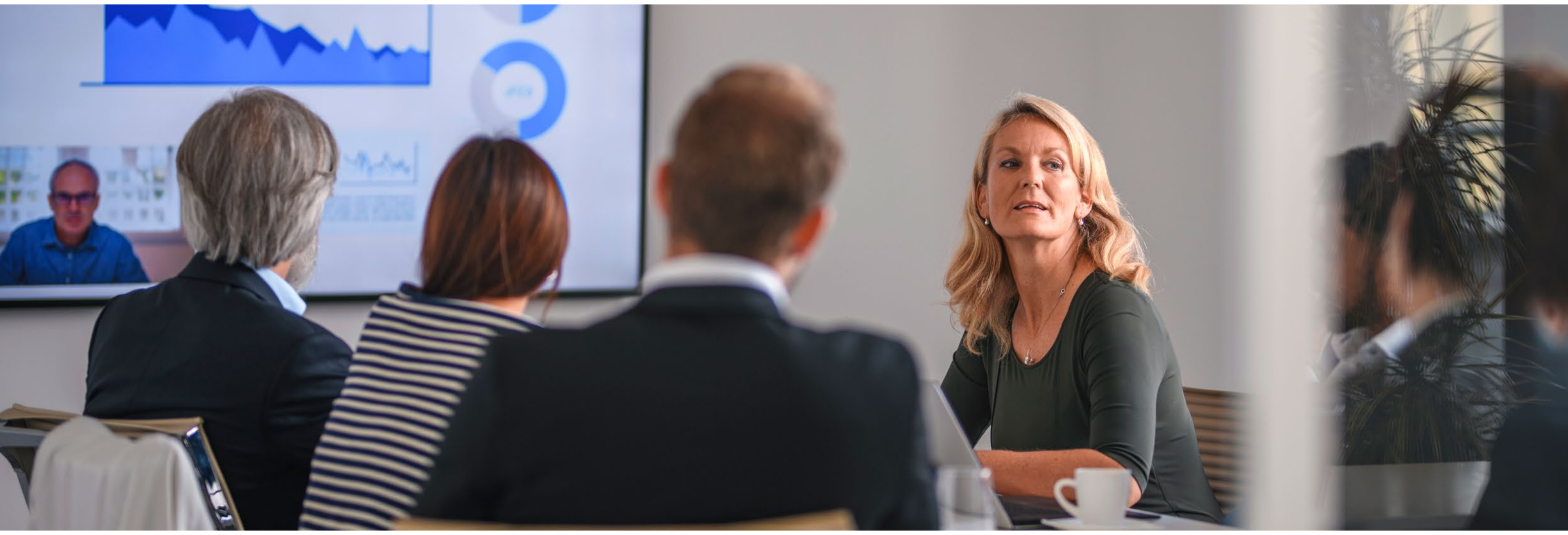
At a glance

- Issuers are increasingly integrating sustainability goals alongside more traditional executive compensation key performance indicators (KPIs).
- If achieved, these can benefit stakeholders beyond just shareholders such as staff, society, and the environment.
- Discover our specific expectations of issuers, from which type of incentive plan to use, to auditing recommendations. We have also included our views on how these KPIs should tie in with corporate net zero commitments.
- Through engagement, we will continue to scrutinise pay packages and engage issuers to share our expectations on incorporating ESG metrics.

Engagement and voting efforts as well as expectations outlined in this Viewpoint reflect the assets of a group of legal entities whose parent company is Columbia Threadneedle Investments UK International Limited and that formerly traded as BMO Global Asset Management EMEA. These entities are now part of Columbia Threadneedle Investments which is the asset management business of Ameriprise Financial, Inc.



Overview

Historically, executive pay has incentivised leadership to increase traditional measures of issuer performance such as revenue or operational efficiency.

Now, as the world shifts its concept of corporate materiality and impact to include environmental and social matters, issuers are increasingly integrating sustainability goals alongside more traditional executive compensation key performance indicators (KPIs). These range from emissions reductions to workplace diversity targets – and, if achieved, can benefit stakeholders beyond just shareholders such as staff, society, and the environment.

In 2021, more than half of S&P 500 issuers[1] – and nearly half of FTSE 100 issuers[2] – included at least one ESG metric in executive incentive plans.

- In 2021, **Shell** increased the weighting of its energy transition condition in the long-term incentive plan (LTIP) to 20%.
- Since 2021, **McDonald's** has factored diversity goals into executive bonuses.
- Since 2020, **Siemens** has weighted 20% of stock awards for its managing board on an internal sustainability index based on three KPIs, including CO_2 emissions

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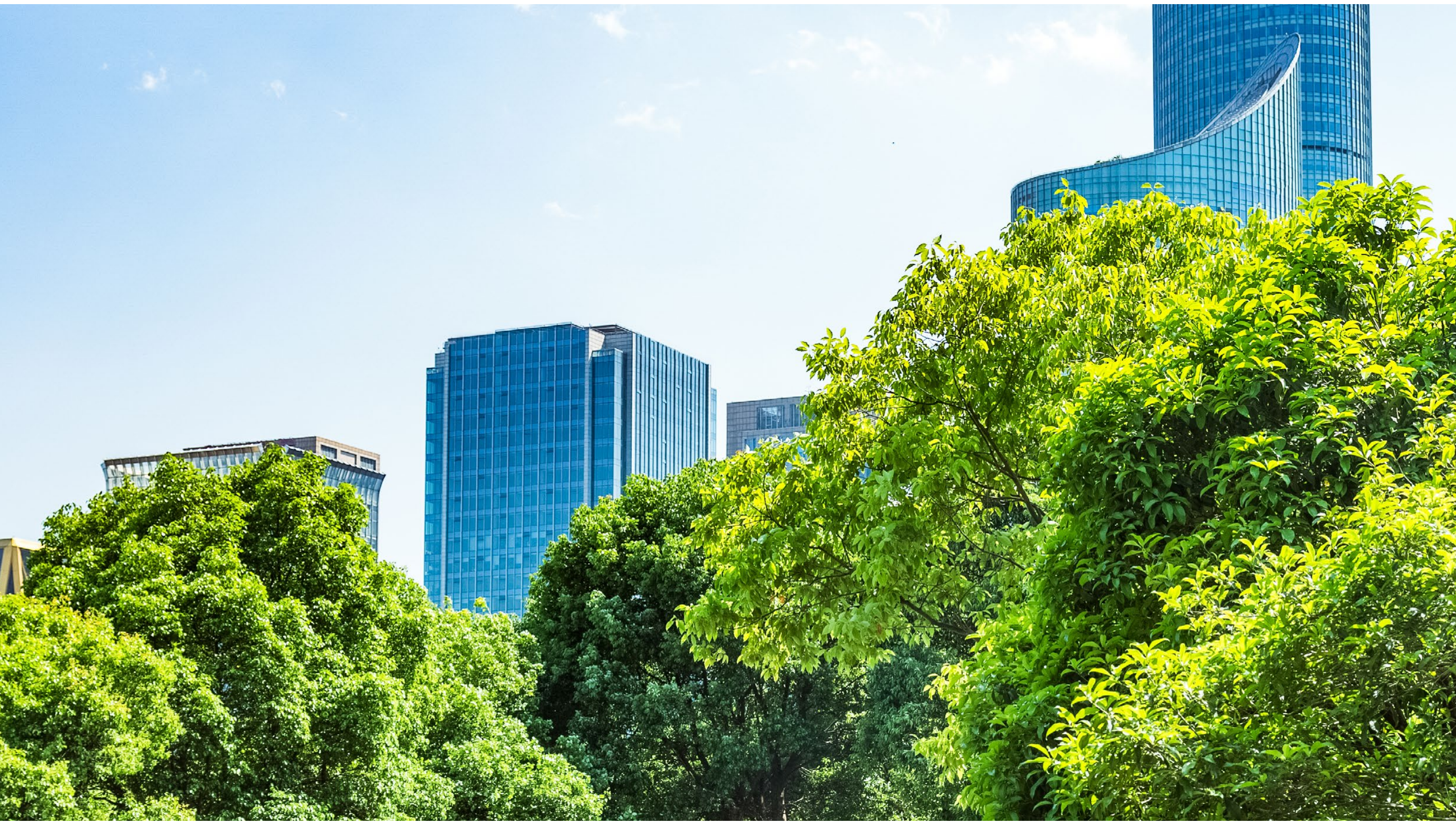
[1] Semler Brossy Consulting Group, ESG + Incentives 2021 report
[2] PWC, Linking executive pay to ESG goals, 2021

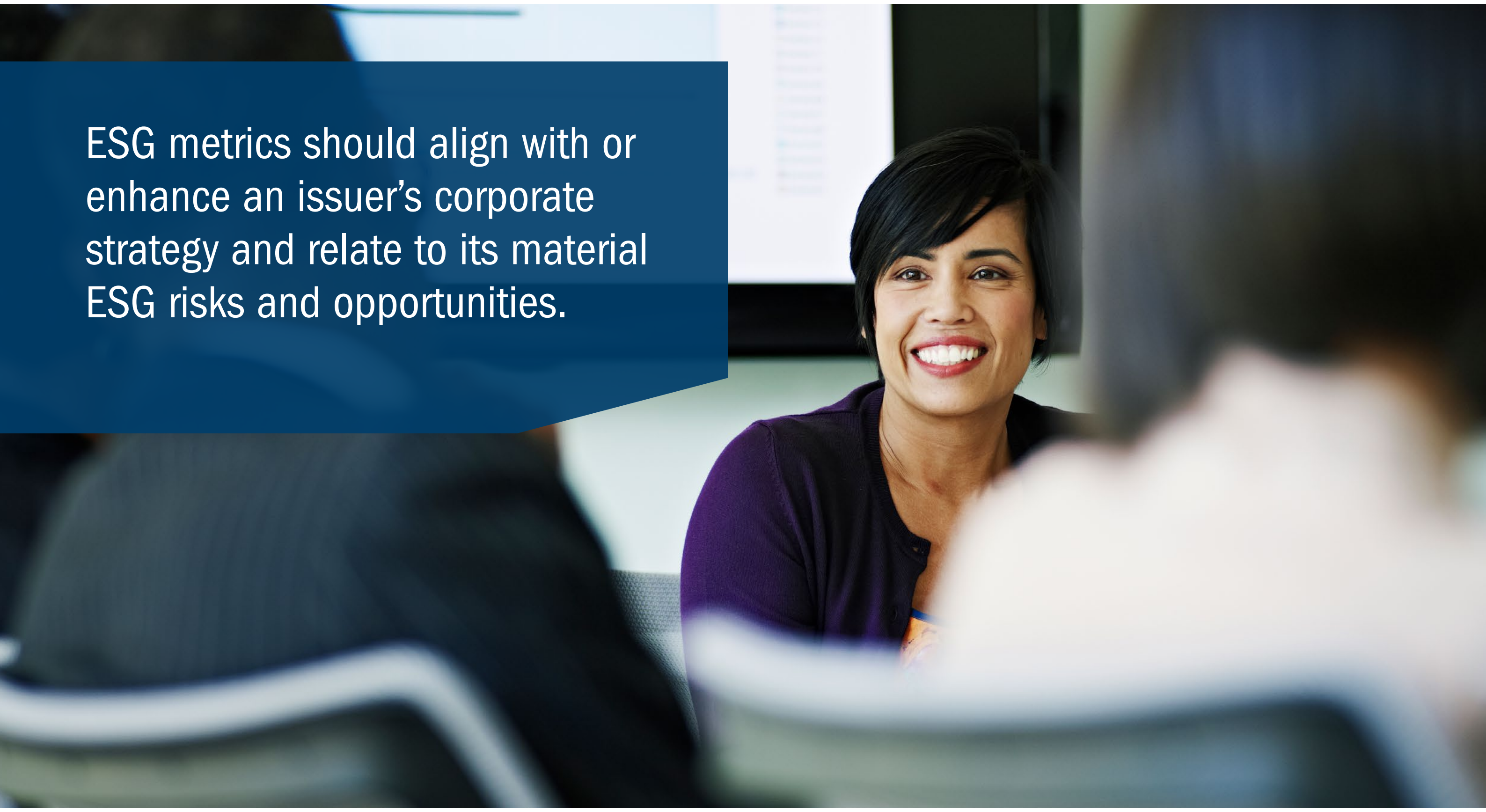


Why are ESG metrics in pay important?

Including ESG metrics in executive pay packages is critical to meeting various corporate sustainability targets. This is important to today's institutional, long-term shareholders.

Whether sustainability targets are met is equally important to other key stakeholders that rely on the issuer such as employees, suppliers, and communities in which the issuer operates. Some arguments to support their inclusion include:

- A growing body of evidence now links sustainability with positive financial performance. Therefore, including ESG targets in executive pay aligns executive interests to shareholder value creation.
- Creates the opportunity to drive real, positive change for staff, society and the environment by incentivising leadership to ensure sustainability goals are met.
- Sends a strong message internally that sustainability is a key business focus area to motivate all areas of the business.



ESG metrics should align with or enhance an issuer's corporate strategy and relate to its material ESG risks and opportunities.

What are our expectations?

We recognise issuers can face challenges in integrating ESG metrics in executive pay, and therefore have set out our specific expectations.

Aligned and material
First and foremost, this is not a 'one size fits all'. We expect issuers to ensure that any ESG metrics are aligned with or enhance their corporate strategy and relate to material ESG risks and opportunities that threaten or contribute to value creation.

Specific and measurable
We expect issuers to set quantifiable and verifiable targets that, if achieved, result in real, meaningful value for stakeholders. Examples include reducing carbon emissions or increasing the percentage of energy generated from renewable sources. By contrast, vague goals – such as enhancing 'sustainability' or 'employee wellbeing' – suggest greenwashing and can undermine both investor and public trust in an issuer.

Internal over external
We encourage issuers to benchmark according to their own internal measures rather than rely on external sustainability indices. ESG ratings often vary by provider and lack transparency around methodologies. They also often fail to provide a clear and verifiable representation of an issuer's sustainability performance when considered on their own.

ESG scorecards
Some issuers may prioritise a small number of ESG matters, thus concentrating the ESG-linked proportion to the most critical sustainability goals. Other issuers may base their incentive weighting on a much wider selection of ESG metrics – a so-called ESG Scorecard. We recognise the merits of both approaches: the former allows for focus and prioritisation, which could lead to stronger progress on a particular material issue, while the latter can encourage an issuer to consider sustainability more holistically and improve on a wider range of issues therefore positively impacting a greater number of key stakeholders. However, issuers must ensure that a scorecard is

Semler Brossy's **2021 proxy season study** of the S+P 500 revealed that Diversity & Inclusion is the most prevalent ESG metric included in executive compensation plans.

sufficiently comprehensive to place enough weight on each of the ESG-related matters, while not becoming so complex that it is difficult to judge.

Short or long-term rewards

We encourage all issuers to thoughtfully consider which ESG metrics should be assigned to the short- versus long-term incentive plans. Although it is possible to imagine substantial overlap in connecting the short-term with the long-term, we ask that issuers avoid overlapping metrics wherever possible. While annual incentive plans may be the easiest way to integrate ESG measures via usage of a modifier, many ESG-related matters are inherently concerned with the issuer's long-term performance. Equally, we recognise the challenge that long-term goals present, such as they may not align with a typical CEO's tenure, therefore making it difficult to find the proper placement. Irrespective of assignment, we encourage issuers to set robust interim targets that incentivise leadership to connect long-term sustainability goals to contemporary targets.

What weighting?

We advocate that the total percentage of variable remuneration based on ESG metrics should be no less than 10%, regardless of whether one or a variety of metrics are selected. We believe weighting within a range of 10-20% is sufficient to incentivise executives while not overshadowing other strategic goals. Nevertheless, we believe there are circumstances where remuneration committees in their discretion may appropriately wish to increase that proportion where the business strategy allows or encourages.

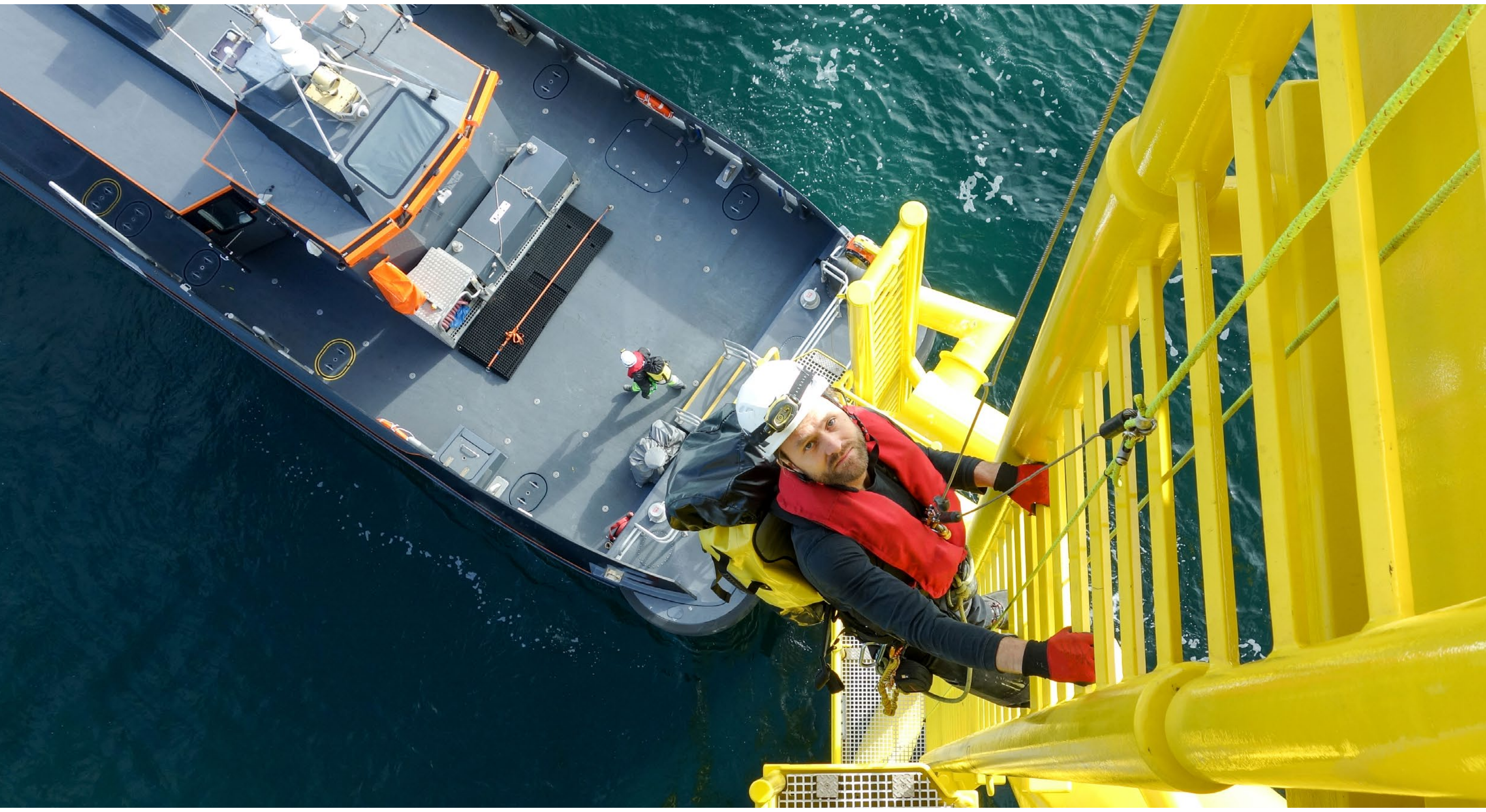
Sufficient disclosure

We expect issuers to provide sufficient disclosure on their ESG metrics in executive pay so that investors can judge their appropriateness. We encourage issuers to provide historical performance against their chosen metrics, to verify that the metrics are stretching management enough.

Auditing

In the UK and Europe, metrics must be audited as part of information disclosed in annual reports. In markets where this is not required, we expect metrics to be externally audited or verified. For example, **Shell's** climate metric, which part of its executive remuneration is based upon, is audited, while **Danone's** climate metric is based on its CDP climate score.

PwC's **study of the FTSE 100** found that **55%** of ESG measures related to pay were tied to bonuses and **50%** were linked to LTIP.



A focus on climate change

Climate change risks are becoming increasingly material to issuers, and many are prioritising their transition to a low-carbon or net zero business within their sustainability agenda. According to the UN's Race to Zero campaign, over 5000 businesses and 400 investors have now committed to net zero carbon emissions by 2050 – a figure likely catalysed by the COP26 climate conference last November.

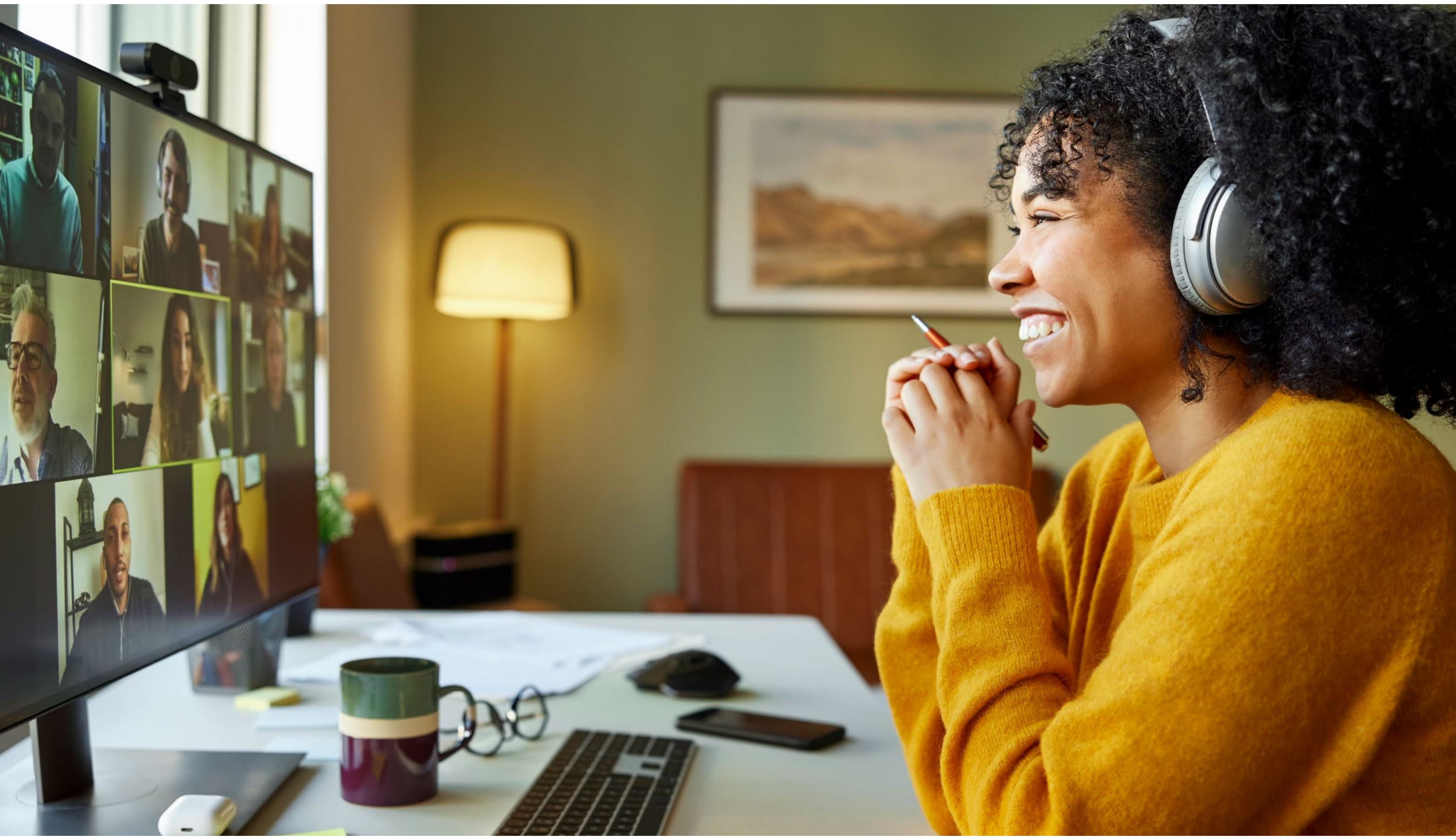
We expect issuers in climate-exposed sectors to set a long-term ambition to achieve emissions reductions consistent with the widely adopted net zero by 2050 goal. We expect them to codify robust strategies to implement this, such as linking executive pay to the achievement of their climate-related objectives.

When setting climate-linked executive performance targets, we expect these to be science-based and account for Scope 1, 2 and (where material) 3 emissions. Given the long-term nature of the 2050 net zero commitment, we also expect issuers to set interim targets that can effectively align to executive incentivisation. Although we recognise the use of carbon offsets in some cases, we expect issuers to focus on decarbonising their operations and value chains before resorting to these and do not encourage issuers to incorporate them into any actions to achieve any climate-linked remuneration awards.

Examples

- **AstraZeneca's** LTIP includes a 10% weighting based on reduction of Scope 1 and 2 emissions.
- **SSE** assesses progress against key sustainability goals under its Annual Incentive Plan (20% weighting), one of which is to cut its carbon intensity by 60% by 2030.
- In 2021, **Shell** increased the weighting of its LTIP on reducing its net carbon footprint to 20%, and increased the weighting of its energy transition metric in its annual bonus plan to 15%.

We expect issuers in climate-exposed sectors to align with the net zero by 2050 goal.



Engagement

Issuers are increasingly consulting investors before introducing ESG metrics to executive pay packages, which has led to very few remuneration proposals being controversial on the basis of the ESG metrics chosen.

In 2021, we briefed a group of 16 primarily UK-listed issuers on our expectations in relation to the introduction of ESG metrics in pay.

During the first two quarters of 2022, we engaged 41 issuers in key sectors (such as oil & gas, mining, materials, electric utilities, transportation and financial institutions) on how executive pay is linked to climate strategy, and informing them of our expectations.

During our engagement, German chemical distributor **Brenntag** highlighted concerns that its link between executive remuneration and ESG could be stronger and is currently under review. We therefore followed up with the issuer to summarise our expectations on how ESG-linked remuneration should look, which was well received by the issuer Chair. Elsewhere, in discussions with semiconductor manufacturer **ASML**, we were pleased to learn of the issuer's decision to increase its sustainability weighting for executive remuneration to 20% of its long-term incentive plan and to employ internal ESG metrics aligned with its sustainability objectives to ensure senior level accountability.

We view engagement as critical to our investment process and to fulfilling our fiduciary duty as active stewards of capital.

Outlook

- As sustainability gains prominence in corporate strategies, we expect to see a growing number of issuers adopt ESG-linked executive performance initiatives as the logical next step in their ESG journey. Earlier in this Viewpoint we highlighted a variety of reasons in favour for doing so, from financial to reputational, beyond a simple desire to 'do better'.
- Through our engagement programme so far, we have been pleased to see some issuers already linking ESG to executive pay and are encouraged that others are open to the discussion. We will continue to scrutinise pay packages and engage issuers to share our expectations on incorporating ESG metrics.

Get to know the author

Andrew Droste, Vice President, Responsible Investment

Andrew is a Vice President on the Responsible Investment Team covering North America, specializing in power and utilities and financial institutions. Andrew joined from the Carbon Tracker Initiative think tank where he was Head of Stewardship and responsible for engaging asset managers on energy transition pathways, including broader net-zero engagement and voting strategies. Prior to Carbon Tracker, Andrew consulted public and private C-suites and boards on material ESG matters at Russell Reynolds Associates after having worked on the stewardship and proxy voting teams at both BNY Mellon and Nuveen. Andrew has a Doctorate of Jurisprudence from Northeastern Law and a Bachelor's in Government from Suffolk University.

Kirsty Nicholson, Senior Associate, Responsible Investment

Kirsty joined the Responsible Investment team in 2021 and focuses on reporting and content. Prior to this, she worked in our Marketing department as an investment writer focused on responsible investing. Outside of work, she enjoys practicing yoga and exploring London's charity shops in a bid to say goodbye to fast fashion. She also takes regular trips home to visit family in Scotland, and has recently enjoyed venturing further afield with the easing of lockdown restrictions.

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