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# The Perils and Questionable Promise of ESG-Based Compensation[1]

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**Evolution of Environmental, Social, and Governance (ESG) metrics-based incentive programs within large corporations:** What impact will they have on the companies themselves and broader society?

**Overall Conclusion:** Bebchuk and Tallarita (BT) raise several significant and valid criticisms/questions of the ESG/stakeholder incentive movement based upon some empirical analysis and their deep understanding of corporate governance, agency theory, and performance.

However, the ESG incentive metrics debate has significant momentum due to substantial pressure on large corporations to include ESG/stakeholder components in executive incentive arrangements. Our view is based upon recent trends of companies considering or including ESG incentive metrics in executive pay plans, an extensive academic literature and business press, in addition to the substantial impetus from employees, consumers, large and small shareholders, public pension systems, Federal and state governments, the media and other external parties.

Most executives and board members believe that their companies already do factor in the treatment of key stakeholders as stakeholder interests are baked into the business strategy essential to survival and success. For example, employee and customer satisfaction are essential to the profitability and overall success of the company and thus, specific stakeholder metrics and goals may not need to be imbedded in incentive plans. However, this perspective — while mostly valid — has been supplanted by events and momentum. Inclusion of such metrics has been embraced by many executives and board members particularly in situations signaling of organizational priorities and performance improvement in specific areas are desired.

We believe that large corporations have undertaken good faith efforts to address ESG incentive issues at the company level, with possible beneficial societal implications. These efforts also reflect board and executive views to make sincere progress on these important economic and societal matters. While specific incentive metrics are an imperfect mechanism (as ESG total impact is much broader than ESG incentive metrics) for implementing ESG, the expectation is that a specific stakeholder group (e.g., employees and/or consumers) will experience better treatment and outcomes. That better treatment, in turn, could have positive spillover/externalities on other stakeholders and society-at-large, and that financial performance will be better over the long-term. ESG incentives could help companies improve their economic and reputational profiles. There is opinion survey evidence that employees strongly prefer that their employer address ESG-type issues and consumers have a similar preference for their purchase loyalty.

## Additional Context

The ESG movement and enhanced stakeholder relations have become significant factors in governing major U.S. corporations. The impetus for these is that major social, economic, and political challenges/problems require environmental, diversity, and equality solutions to change U.S. society for the better. Public corporations, along with government, are seen as two of the major positive institutional catalysts that can implement these changes and address these problems.

Both ESG and stakeholder-focused initiatives have the potential to help companies be more successful in terms of increased growth/profitability, enhanced corporate image and improved operational and reputational risk profile. As a result of these pressures/phenomena, ESG is becoming imbedded in corporate governance and culture, especially in the goals/metrics of executive short and long-term [stock] incentive plans. These metrics are very powerful, but not without their challenges and controversies.

We have observed first-hand *the difficulty of* ***setting disclosable quantitative ESG incentive goals.*** The ideal solution balances the numerous tensions of setting appropriate/stretch-goals that will drive improved ESG outcomes for a new series of metrics without demotivating management nor creating litigation risk. Further, i**t is imperative that the company be "ready" for this next step, *and many are not ready.* This is why there are hundreds of companies with ESG incentive metrics that are qualitative and holistic and not quantitative so that they can move forward on this important journey. In our experience, we know that companies *are pressured by their* shareholders to set quantitative goals aligned with their long-term strategies rather than qualitative goals.**

Many corporate executives/directors and outside advocates sincerely believe that ESG and stakeholder relations are important to running a successful company in today's environment. Positive ESG and stakeholder outcomes create positive feedback loops for employees, consumers, and local/national communities (see graphic below). While making progress, this a highly uncertain, risky, and controversial area, as there can be winners and losers on both sides.

More than half of large companies have added some type of ESG metrics to their business plans and their incentives. We expect this share to continue to increase. There are myriad ways of selecting metrics and goals for the design of the incentive, endorsing one of Bebchuk and Tallarita's (BT's) observations. While it is early in this movement, to link executive pay to ESG metrics, there are many parties interested in encouraging sincerity, success, and impact for these companies.

## How is the ESG Movement Impacting Company Performance and their Corporate Social Responsibility

BT have written two seminal, creative, and thought-provoking papers criticizing the corporate stakeholder/ESG models. They focus specifically on the impact that these models could have on corporations in terms of being more successful overall while also being good corporate citizens and, more broadly, on the hoped-for improvements to our overall economy and society via strong corporate leadership and demonstrable success in this stakeholder arena.

This ESG incentive movement is occurring in the current environment with large and small shareholders and the media pushing these companies to create effective and responsible corporate governance that benefits all stakeholders, and not just shareholders. **BT argue that adding ESG metrics to U.S. corporate incentive plans is basically *less effective* than doing nothing. This lack of effectiveness is created by the current ESG incentive metrics being too narrow to make a difference on stakeholder benefits and by the distraction from more effective efforts, e.g., government intervention. Their "analysis identifies two structural problems with ESG metrics"[1]:**

1. **Will these incentives create additional real value for stakeholders and shareholders? "Are ESG compensation metrics an effective tool to improve stakeholder welfare?"**Error! Bookmark not defined. BT point out that the current slice of ESG incentive metrics is very narrow relative to the totality of stakeholder challenges and thus their impact is modest/nil. That is an accurate representation but has a satisfactory explanation: companies are focusing on specific metrics where they can make a difference (e.g., Diversity, Equity, and Inclusion [DEI]), and these efforts represent very early initiatives at the beginning of this movement. Thus, the possibility remains that those metrics may not improve the overall stakeholder experience but may distract executives from important operating and other goals.

2. **Will the ESG incentive movement distract/divert attention from the substantial progress in making pay more transparent and aligned with the company's performance**? If so, this could yield substantial, real economic damage, as corporations are a major driver of economic success.

They evaluate two scenarios:

- if ESG incentive metrics are impactful, then those companies would substantially improve the treatment of all stakeholders and make positive contributions to the environment and society at large.
- if ESG metrics are not effective in current form and difficult to improve, then it is not likely that there will be improvements to stakeholders and overall society from these corporate strategies.

**We are early in the stakeholder/ESG movements in general and covering incentives in particular, but *companies are certainly trying to be supportive for many reasons.* This is positive, as it is a step in the right direction. However, the narrow metrics and their modest weight relative to the total executive pay package means it is unlikely to distract executives from improving overall corporate performance. However, at this stage, the obverse of that "limited distraction" from that *modest weight likely would limit the positive impact on stakeholders.* But it is a beginning which provides internal and external signaling of an important corporate strategy with potential substantial impact.**

## The Facts/Context of Adding an ESG/Stakeholder Metric

**Here are some facts/impressions demonstrating the mounting investor, social, political, and economic pressure/influence on corporations to include an ESG metric in incentive plans:**

1. **There is substantial internal and external pressure on major companies to include and focus on ESG/stakeholder metrics.**
    a. **Employees:** Employers that have high employee satisfaction and attractiveness to talent, have higher ESG scores.[2]
        i. **86% of employees want to work for companies with the same ESG values as the employees have.**

    b. **Consumers:** 83% of consumers want business to focus on ESG issues.[3]
        i. 66% of consumers in another survey include corporate sustainability in their consumer decisions.[4]

2. **"91% of business leaders believe that their company has a responsibility to act on ESG issues"[5] This is supported by our consulting experience which indicates that many top executives are highly-motivated and receptive to include an ESG/stakeholder metric in the**

**incentive plans.** It appears to us that these executives are motivated by personal conviction as well as good governance and strong shareholder alignment. However, there is a common belief that this needs to be implemented carefully and with strategic linkage to the business.

a. Companies are facing conflicting/competing pressures: **investor pressure to keep improving profits/stock price while adding ESG metrics with specific goals[6] versus possible legal implications and other risks from falling short of a specific goal. It is likely that ESG/stakeholder focus on some ESG metrics can have significant costs in the short-run (especially climate/pollution) but potentially can improve long-term performance, but that is not guaranteed.[7] This is not a trivial issue as it is also not guaranteed that the ESG performance will improve.[8]**

3. **86% of investors want an ESG metric in their incentive plans.[9]**
    a. 52% of investors want measurable goals.[10]
    b. 49% of investors would sell their stock if they were disappointed in a company's ESG initiative.[11]
    c. 41% of investors would support ESG metrics even if they conflicted with shareholder value creation; 42% of investors disagreed with that approach.[11]
    d. More than half of the studies in ESG economic meta-studies have found a positive relationship between ESG and financial performance. These studies need to be used carefully to avoid the "correlation = causation" trap. For example, the tech industry is much "cleaner" than manufacturing, so their investors, employees, and consumers are already attracted to those clean companies. For example, several major sectors of the tech industry are much "cleaner" than manufacturing, so their investors, employees and consumers are already attracted to those clean companies. For example, Top 100 Polluters list[12] is comprised 100% of energy companies—power companies and oil/natural gas—there are no tech, financial services, retail, pharma, etc.[13] Nevertheless, this an important statistic that needs to be used prudently.[14]
    e. Evolving governance views by all investors indicate that both large and small investors are supportive of ESG. The recent successful proxy duel over carbon emissions at Exxon was initiated by a relatively small ($\ll$0.1%) investor. They were able to capture three board seats, and it appears that Exxon has already begun to make substantial changes (e.g., Canada tar sands and "zero emissions from operations").[15,16]
    f. 73% of selected other expert respondents (companies, lawyers, consultants, etc.) to the ISS survey supported an ESG metric.[9]

4. **57% of large companies have already added an ESG metric.**[17] This is up substantially from an estimated 10-15% a few years ago. Our recent consulting experience is that the proportion with ESG metrics will continue to rise.
    a. There is a history of safety and customer satisfaction incentive metrics and a few other ESG metrics in incentive plans at selected industries (utilities, manufacturing). **However, it is clear that the ESG community is pushing companies to do much more than has been done historically**.
    b. Many of these metrics are human capital and customer-based.
    c. The vast majority of these companies add these metrics to their annual/short-term cash incentive/bonus, with the remainder in long-term performance shares. The weight varies but is broadly within a range of 10-30% of the short-term incentive, with most at the lower end. This yields 2-5% of total pay for an executive.

d. There is compelling logic to put these metrics in the long-term incentive plan (performance shares), which has a larger impact on executive compensation and thus would give the ESG metrics more valence. However, the current lack of reliable external benchmarks, limited public information among other impediments makes ESG goal setting, challenging.

5. **94% of directors support the usage of non-financial goals** — which include ESG and stakeholder metrics — with the dominant support for customer satisfaction, safety, and DEI.[10]
    a. **However, fewer companies utilize one of those metrics**.[10]

6. Most large companies use their board members and executives to **conduct annual or more frequent "shareholder outreach"** meetings, which are reported to management and the full board. **One of the most common shareholder comments in those meetings is the importance of adding an ESG metric to an incentive plan.**

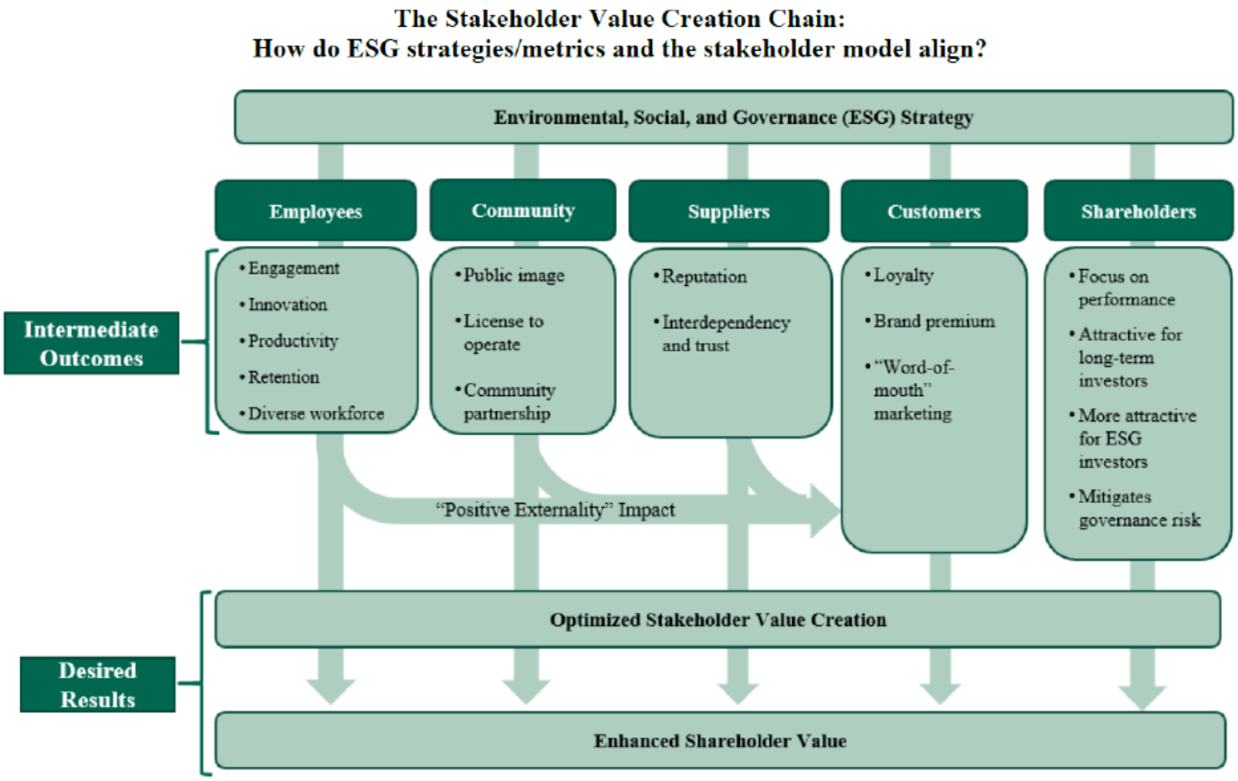
7. **Many of those companies use a holistic/qualitative approach** including a scorecard, as companies are not prepared to make firm goal commitments but are making good faith efforts. This likely will evolve over time under additional pressure, but this is an area that needs careful assessment.

8. **Our experience is that for some companies, the ESG/stakeholder payouts hover around 100% of target.** In 2021, we know several examples where the ESG metric rating at 100% reduced the very strong interim weighted payout from their financial results (PG experience) There is limited empirical research on the payouts, but we found one recent study of 13 very large companies with ESG metrics, and the payouts for 12 were well below 1% of total compensation.[18]

## Conclusion

It is early in the process of incorporating stakeholder metrics into corporate culture and incentive plans. The U.S. corporate sector seems highly motivated to be good corporate citizens. The challenge for broad participants is to improve all stakeholders' status without damaging the highly successful U.S. corporate sector. This will require ongoing careful monitoring of how this evolves with continuous improvements.

## Appendix

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