PRI Principles for Responsible Investment

Integrating ESG* issues into executive pay

*Environmental, Social and Governance

Guidance for investors and companies

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THE GLOBAL COMPACT

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Environment, social and corporate governance

Environment (E)	Examples of environmental issues include biodiversity loss, greenhouse gas (GHG) emissions, climate change impacts, renewable energy, energy efficiency, resource depletion, chemical pollution, waste management, depletion of fresh water, ocean acidification, stratospheric ozone depletion, changes in land use, and nitrogen and phosphorus cycles.
Social (S)	Examples of social issues include activities in conflict zones, distribution of fair trade products, health and access to medicine, workplace health safety and quality, HIV/AIDS, labour standards in the supply chain, child labour, slavery, relations with local communities, human capital management, employee relations, diversity, controversial weapons, and freedom of association.
Corporate Governance (G)	Examples of governance issues include executive benefits and compensation, bribery and corruption, shareholder rights, business ethics, board diversity, board structure, independent directors, risk management, whistle-blowing schemes, stakeholder dialogue, lobbying and disclosure. This category may also include business strategy issues, both the implications of business strategy for environmental and social issues, and how the strategy is to be implemented.

Integrating Environmental, Social and Governance issues into executive pay: guidance for investors and companies

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PRI Principles for Responsible Investment

I. Executive Summary

The recent focus on executive remuneration has demonstrated the challenges for investors to assess complex pay packages and corporate performance. Existing remuneration plans for senior executives do not necessarily promote sustainable value creation for their companies. However, the inclusion of appropriate Environmental, Social and Governance (ESG) issues within executive management goals and incentive schemes can be an important factor in the creation and protection of long-term shareholder value.

Within this context, the UN-backed Principles for Responsible Investment initiative and Global Compact LEAD (a leadership platform within the UN Global Compact) have facilitated discussions between a diverse group of institutional investors and companies to identify the rationale, feasibility and effectiveness of corporate practices which include Environmental, Social and Governance (ESG) factors within executive management goals and incentive schemes.

The main objective of the resulting guidance is to **support and enhance the investor-company dialogue** on these practices. The set of recommendations and guidance points presented aspire to reflect **a common understanding of major opportunities and challenges, as well as practical examples**. This document will therefore provide a **tangible engagement tool** to guide dialogue between shareholders and investee companies on this topic, and help improve corporate boards' practices to the benefit of both companies and their investors.

More specifically, dialogue amongst the members of the group has identified three main areas of discussion:

1. how to identify the appropriate ESG metrics for each company;
2. how to link these metrics to executive pay packages; and
3. how to provide high-quality disclosure on such practices.

With these three questions in mind, this publication utilizes a three-tier structure to develop a series of overarching recommendations for investors and companies to consider.

Companies should adopt a clear process for identifying appropriate ESG metrics that relate to sustainable shareholder returns and company strategy. In an effort to provide further guidance, the following key points have been identified:

1.1 ESG metrics should have a clear link to the optimization of shareholder value and be aligned with the long-term business strategy

1.2 Companies are encouraged to develop their own definition of sustainable value creation and use it to select appropriate ESG metrics

1.3 In identifying ESG metrics, a company should consult with its shareholders and attempt to achieve a thorough stakeholder mandate to enhance internal and external support

1.4 Companies should focus on ESG metrics that are generally forward looking, clear, attainable, replicable, comparable and time-bound

1.5 When selecting key ESG metrics to be tied to compensation, companies should ensure balance, diversity and relevance

Companies should link appropriate ESG metrics to reward systems in a way that they form a meaningful component of the overall remuneration framework. Key guidance points:

2.1 ESG targets should be integrated into an appropriate time horizon that is in line with business strategy

2.2 ESG targets should be stringent and challenging to ensure incentivizing outperformance

2.3 Companies should select appropriate mechanisms and structures when creating incentive pay packages to ensure long-term shareholder value creation

2.4 Incentive compensation should be subject to downward discretionary adjustments by the compensation committee to account for unusual events or unintended consequences as well as claw-back provisions

2.5 In quantifying ESG metrics and measuring performance, the board may apply a clearly substantiated degree of discretion

Companies should endeavor to disclose the rationale, method and challenges presented by the incorporation of ESG metrics into executive pay clearly and concisely. Key guidance points:

3.1 There should be clear disclosure of the rationale in identifying ESG metrics linked to executive compensation and evidence of alignment with business strategy and shareholder value

3.2 Disclosure of metrics and performance targets should be understandable and there should be clear and concise information regarding the structure and mechanisms used in linking ESG metrics to compensation

3.3 Disclosure should provide sufficient information to allow investors to assess performance against ESG goals

3.4 Disclosures of relevant ESG goals and their associated links to compensation should be integrated into official pay disclosures

The PRI Secretariat and the UN Global Compact Office hope that this publication will provide an opportunity for further dialogue and collaboration between investors and companies with the aim of clarifying expectations and identifying next steps in the integration of appropriate ESG factors into executive remuneration.

"At Legal & General Investment Management, we have long been pushing for a close alignment of executive pay with companies' long-term strategies and operational successes. Integrating key ESG metrics is a natural progression towards holding executive management to account for sustainable delivery of business goals. We have already seen encouraging developments in many companies, and believe this framework will assist other companies to develop a meaningful incentive structure."

Meryam Omi, ESG Engagement Manager
Legal & General Investment Management

"APG considers a strategic approach to sustainability an integral part of good corporate governance, and has long been engaging with companies on how they take account of the all relevant factors in setting and executing their strategy. With regard to the integration of ESG issues into remuneration strategies we always look at it from the point of value creation. We considered the cooperation between the PRI and LEAD an excellent platform for developing guidance that builds on both companies' experiences and investors' expectations."

Claudia Kruse, Head of Governance & Sustainability
APG Asset Management

"Amalgamated Bank's LongView Funds look for companies to disclose how they intend to generate long-term value and to demonstrate how their executive pay plans are aligned with firm performance. When and where appropriate, we believe that ESG pay incentives may create upside opportunities for enhanced growth and safeguard investors from the downside of ESG risks. Accordingly, we welcome productive dialogue among companies and investors on how best to identify and incorporate robust and relevant ESG incentives."

Scott Zdrazil, Director of Corporate Governance
Amalgamated Bank

II. Introduction

Executive remuneration constitutes one of the major elements of corporate governance dialogue between institutional shareholders and investee companies. It is generally accepted that the role of executive pay arrangements should be to incentivize superior performance. Moreover, remuneration packages should be structured in such a way as to optimize financial results and promote sustainable behavior without generating or exacerbating systemic risks that might undermine investors' long-term interests.

As part of the trend of designing more sophisticated pay packages, boards have started exploring different ways for integrating ESG factors in incentive mechanisms for senior management. While emerging practices are taking shape, there is no universally agreed guidance on how to link ESG metrics to executive pay. Companies from different sectors and industries are affected by particular market forces and face multiple constraints resulting in the varying materiality of different ESG factors. For example, while environmental issues may be particularly relevant for companies with a large carbon footprint, other industries may decide to focus more attention on community relations and stakeholder engagement to protect their license to operate or ensure health and safety in their workforce.

Considering the potential influence of ESG factors on performance, ideally all companies would link executive compensation to key ESG metrics. However, in some cases this may not be practical because of the difficulties in measuring ESG factors or the lack of evidence of these ESG factors' exact impact on overall company performance. Companies are encouraged to consider ESG metrics that are relevant for their business and clearly disclose the rationale for linking them to executive pay. Likewise, companies that have chosen not to integrate ESG components in compensation packages should provide adequate explanation for why integrating ESG factors would not have been considered appropriate, following a "comply or explain" approach.

As stewards elected by shareholders, boards of directors are charged with safeguarding shareholder value. Furthermore, boards are responsible for overseeing that management efforts in creating value are both competitive and sustainable. In view of these duties, boards should be provided with sufficient resources to thoroughly evaluate and mitigate exposure to ESG risks. Boards should therefore have a deep understanding of business goals and associated strategies, as well as incentive structures that appropriately align the interests of management with those of shareholders.

Board level oversight is the key factor in ensuring ESG metrics are both relevant and embedded in a company's broader strategy. As ESG issues can influence viability, it is crucial that the boards consistently discuss and monitor the selection, design and verification of comprehensive metrics, goals and related achievements to be linked to executive compensation.

Companies should determine the types of board committees that are most appropriate for oversight duties related to sustainability. While some boards may choose to place this role in a more traditional structure, such as with the nominating and governance committee, others may choose to dedicate an entire committee to ESG issues, depending on the level of exposure of a company or industry to such factors.

Companies are also encouraged to adapt board and committee charters in order to reflect their duties in ensuring that ESG targets are appropriately

crafted, awarded and verified. Clearly defined roles and responsibilities on ESG factors signal to investors and the broader community that these factors play an important role in a company's overall strategy and direction.

The entire board may find it helpful to work in conjunction with independent third-parties to verify ESG data and determine the company's and/or executives' performance relative to established metrics.

As discussed above, while there is no "one size fits all" approach to integrating ESG factors in remuneration policies, the task force involved in this project has identified several potential opportunities and positive effects of integrating ESG metrics into executive pay:

- Aligning executives' incentives with long-term strategic plans contributes to the delivery of sustained shareholder value creation;
- Long-term thinking about the company's future performance and tangible leadership from the top is rewarded, and senior management is held "accountable" for sustainable performance;
- Identifying key ESG value drivers and risks relevant for each specific company and sector triggers new business opportunities and costs savings;
- ESG issues are more likely to be integrated into the company's dialogue with shareholders on its business strategy, effectively acknowledging their impact on corporate performance.

However, a number of challenges in linking ESG metrics to executive compensation packages have also been identified:

- The lack of a universal standard of reference for board, top management and remuneration consultants to assess relevant ESG risks and opportunities;
- The risk of creating perverse incentives or additional ways to pay executives without concretely promoting a holistic approach towards sustainable performance;
- The potential for companies to include ESG criteria based on easily measurable metrics rather than issues that are more relevant or material for their business;
- The potential for different performance factors to compete with each other within compensation packages and remuneration reports which are already lengthy and difficult to read.

III. Overarching Recommendations and Guidance Points

1: Identifying Appropriate ESG Metrics

Recommendation I: Companies should adopt a clear process for identifying appropriate ESG metrics that relate to sustainable shareholder returns and company strategy.

Guidance Point 1.1

ESG metrics should have a clear link to the optimization of shareholder value and be aligned with the long-term business strategy.

The ESG metrics which are integrated into executive pay should be selected in order to promote sustained company success and the creation of long-term shareholder value. Moreover, these factors should be aligned with the broader company strategy and key performance indicators to encourage the efficient use of capital and reduce risks. Companies should articulate their plans for delivering sustained shareholder value creation and align executives' incentives with those plans to mitigate related risks.

Company-wide strategies that consider ESG issues ensure focus on sustainable, long-term growth. By encouraging employees at all levels to internalize ESG values, a company is more likely to have a successful, measurable, and relevant strategy to foster sustainable practices. Just as ensuring financial targets are met via cost efficiencies throughout an organization, engaging the workforce in a strategy that encompasses all levels and divisions is more likely to result in benefits for the company.

By embedding ESG metrics into a broader strategy, a company may be able to more efficiently allocate resources. By having a long-term view from both a financial and ESG perspective, a company is in a better position to direct resources and attention to strategic goals. Furthermore, by placing these metrics in the framework of a larger corporate strategy, a company can provide more effective oversight of these goals and measure its performance.

Finally, there needs to be a balance between those metrics that create value and those that protect value. As such, ESG metrics should include factors that both mitigate potential risks for the company and allow for new opportunities for a company's growth. It is important that companies consider risk management and growth opportunities not only to ensure their efforts safeguard shareholder value from accidents, reputational damage, scandals and fines resulting from law violations, but also to allow for continuous long-term profitability. Both the upside and the downside of ESG issues should be considered when constructing and evaluating such metrics.

Guidance Point 1.2

Companies are encouraged to develop their own definition of sustainable value creation and use it to select appropriate ESG metrics.

Sustainable value creation can and should have different definitions for every company. Thus, it is crucial that companies look at the long-term viability of their operations and conduct assessments in order to define appropriate ESG metrics that will comprise their unique definition of sustainable value creation. On the other hand, the need to ensure a proper governance structure is in place and business is conducted in an ethical way is applicable to all organizations.

Factors that are likely to affect a company's definitions may include (among others): type of industry; local, national, or supranational regulations and investigations; global and local economic conditions; access to resources and capital; environmental conditions of operating environment; political conditions of operating environment; workforce composition and access to desired workforce; values held by an organization; location of headquarters and major operations; and growth opportunities. ESG metrics related to performance or inclusion in external sustainability indices are strongly discouraged as they are rarely specific to companies' particular situations and circumstances.

Guidance Point 1.3

In identifying ESG metrics, a company should consult with its shareholders and attempt to achieve a thorough stakeholder mandate to enhance internal and external support.

Companies require a license to operate, either implicitly or explicitly, from the communities in which they operate and by the individuals and groups who can affect or are affected by their organizations. Companies can gain broad support for their strategy if they ensure that their efforts are aligned with the interests of their shareholders and the broader community. By engaging with key internal and external stakeholders in the process of developing ESG KPIs and subsequently defining ESG metrics by which to measure and incentivize sustainable value creation, companies are more likely to receive strategic inputs and collect feedback that they would otherwise be unable to ascertain . By receiving broad consensus, companies not only gain valuable insights for their business proposition, but also appear more responsive to the needs of their stakeholders and build goodwill and support from those parties with whom they engage.

Input should be gathered from relevant bodies, which include (but are not limited to): investors; investor coalitions; employees; customers; NGOs; trade unions; regulatory and government bodies; suppliers and contractors; local communities; and industry associations.

Guidance Point 1.4

Companies should focus on ESG metrics that are generally forward looking, clear, attainable, replicable, comparable and time-bound.

By placing time-bound goals in the context of long-term strategy, a company will be able to meet initiatives and respond to changing conditions by altering shorter-term goals when necessary. It is crucial that these goals are realistic and clear enough to have a finite outcome, but also allow room for adjustments over the long-term.

Managing risks that are not tangible and measurable can prove very challenging. Therefore, companies should select and employ rigorous ESG metrics that are tied to the broader corporate strategy and ensure they are unambiguous and time-bound. By ensuring that companies are clear about their goals and direction regarding their ESG initiatives, they will be able to set in place incremental targets that will deliver meaningful benefits over time. The construction of challenging, yet attainable, specific and direct targets will help companies set priorities and allocate the necessary resources to ensure that all who are involved witness a clear direction and outcome.

Metrics must also be relevant and measurable to allow investors to compare companies and their peer groups.

Guidance Point 1.5

When selecting key ESG metrics to be tied to compensation, companies should ensure balance, diversity and relevance.

Once a company has incorporated key ESG metrics into its broader corporate strategy, it must decide which areas should be tied to executive compensation. While a company's definition of sustainable value creation is likely to encompass a variety of unique metrics, it is important that companies refine these in order to create clear performance indicators to be linked to executive pay. Companies should aim at identifying metrics that are sufficiently diverse in order to avoid excessive concentration on a specific issue to the detriment of a broader vision of ESG performance. However, companies are also encouraged to focus on a select number of key metrics, rather than a large assortment, to prevent against incentives being diluted and ensure clarity and focus towards meeting goals.

Once key metrics have been established, companies should take into account which goals require individuals to play a fundamental role in order to be realized. Therefore, and again without missing the bigger picture, the company may identify certain metrics that are more relevant for specific executives' pay packages.

Case Study 1

Company Name: Stockland

Sector: Property

Country: Australia

Introduction

Stockland is a diversified property group that develops and manages a large portfolio of residential, community, retirement living, retail and industrial assets. Stockland operates mainly in Australia with residual operations in the United Kingdom. As a company that develops and holds property assets, sustainability and sustainable development are key considerations in its larger business strategy. Stockland is an active participant in the international pilot on integrated reporting and has identified sustainable practices as a value proposition to its customers. The company has been integrating ESG metrics in compensation plans for a number of years and is further exploring development of such metrics and ways that they can deliver clear financial performance through the attainment of sustainability goals.

Stockland has a very rigorous process of stakeholder engagement, both directly and indirectly as a means of identifying ESG performance metrics. The company surveys customers, engages with governments, receives feedback from clients and reviews media activity in order to determine materiality of these metrics. The company also engages closely with its risk and strategy leaders in order to ensure these metrics' alignment with corporate strategy. Stockland ultimately refines these metrics in order to produce a balanced scorecard that is fully reflective of the organization, from which remuneration-linked metrics are determined for every employee in the company. Stockland's balanced scorecard comprises four key categories, with financial and business-related performance holding the most weight. The balanced scorecard also includes factors related to stakeholders and customers, people and leadership, sustainability, health and safety.

In order to construct remuneration packages, each employee is given four to six total objectives from each of the balanced scorecard's categories, with a minimum weighting of five per cent for ESG-related metrics; typically between 10-20 per cent of executives' incentive remuneration is based on ESG metrics from the sustainability, people and stakeholder dimensions of the scorecard. For most executives, people and leadership, stakeholder and customer, and sustainability health and safety comprise approximately 40 per cent of total short-term incentive weighting; however, there are specific ESG objectives and weightings for different groups within the organization. The company used to rely entirely on external surveys, such as the Dow Jones Sustainability Index as an ESG metric, but now increasingly focuses on internal metrics that sit within its overall strategy - although it does still employ the use of external surveys in its overall portfolio of metrics. Stockland states that it is still looking for more defined metrics and actions in order to show detailed outcomes to shareholders and in order to prove a link between its ESG metrics and value creation.

The company previously employed a formulaic approach to each of the factors in its balanced scorecard, whereby each of the four objectives would be weighted and multiplied by the results for each performance score. This approach would allow for large bonuses if employees performed in the heavier weighted categories, which were typically financially related categories.

However, Stockland has recently revised its assessments to be based on an overall performance assessment, not just the assessment of specific objectives, which ensures that targets do not get ignored and that all executives were engaged in categories to affect the company's long-term performance. Stockland believes this approach better aligns individual behavior with the values of the business and that its remuneration policy helps executives focus on these values. For example, if an executive has an objective that is tied to health and safety in the workplace, and a serious incident occurred, it would previously only account for 10 per cent of the bonus. However, under the company's new scheme, the bonus would be cancelled out because of the overall performance assessment.

Key Takeaways:

- Stockland derives **ESG metrics from engagements** with key stakeholders in order to build broad consensus and achieve **new perspectives on its ESG strategy**;
- The company has established a **balanced scorecard approach** that contains a host of financial and ESG metrics;
- **ESG objectives are uniquely designed for individual groups** (job families) within the company in order to achieve optimal performance; and
- Stockland constructs compensation packages that do not allow full bonuses to be paid out when executives underperform on either financial or ESG metrics.

Case Study 2

Company Name: Intel

Sector: Information Technology

Country: United States

Introduction

Intel Corporation is a U.S. company that designs and manufactures integrated digital technology platforms. Intel is widely known for its sustainability initiatives and has been providing a link between ESG metrics and compensation since 2005. The company's ESG remuneration elements focus on community, brand equity, cost-savings and revenue generation. Intel believes that its sustainability initiatives should be bottom-line focused and its wide attention for ESG issues is key to its long-term growth strategy.

Beginning in 2005, Intel started linking its bonuses to ESG metrics. The company's annual incentive programs are comprised of three elements: (i) financial performance; (ii) financial performance relative to peers; and (iii) operational goals, which encompass approximately 300 line items. The company first began to tie compensation to sustainability as specific line items that fell under employees' operational goals. Intel still links compensation to ESG factors in its incentive plans in this way; however, the company has established a larger proportion of metrics that are ESG in nature under its operational goals. Line items include factors such as the company's carbon-footprint and cost savings from recycling, which are included as one of five categories which operational goals are subsequently scored on. These ESG goals amalgamate to approximate 20-25 per cent of operational goals, which are applicable to every employee in the organization. Intel only links short-term incentives to ESG metrics and awards equity compensation based purely on financial metrics, such as share price and total shareholder returns. Intel views equity incentive plans as designed to keep employees focused on its share price, while its annual incentive plans as designed to focus employees on the operational and financial health of the company over the long-term (despite its nature as a short-term incentive scheme).

Due to the highly subjective nature of many ESG metrics and the highly formulaic approach to its compensation model, Intel has had some challenges in defining appropriate metrics. For example, it states that some metrics are easily quantifiable, (such as savings realized through recycling efforts) while others may be more challenging to quantify (such as employee satisfaction or morale). Intel is also wary of setting ESG goals relative to peers, as many sustainability practices are still in their nascent forms and relative positions can be hard to measure or may be completely irrelevant or inaccurate.

While there was initial skepticism for its ESG initiatives due to the uncertainty about the link between financial and ESG performance, the company found that positive ESG practices have been beneficial to the company's overall performance.

Intel does not have a board-level committee that is in charge of its ESG initiatives; however, the company states that due to its long-standing commitments to ESG issues, these have been embedded within the entire organization. Intel ensures that it remains focused on sustainability through meetings of senior leaders, which take place every two months and are purely focused on the company's ecological impacts.

While Intel has established elaborate, relevant and specific formulations to incorporate ESG metrics into employee compensation, it does not disclose this information in its annual proxy statement. The company states that this is partly due to the tension between its goal to simplify its compensation discussion and analysis and its desire to produce a comprehensive disclosure of its compensation practices. Furthermore, for competitive reasons Intel cannot disclose many of the line items used in its operational goal assessment, and is concerned about the impact of providing a partial list.

Key Takeaways:

- **ESG issues are embedded throughout the organization** and all employees are held accountable for their efforts toward Intel's sustainability initiatives;
- All employees, including executives, are compensated based on ESG metrics that are derived from **individual metrics**, created to incentivize desired outcomes;
- Intel incorporates a **wide variety of ESG metrics to its operational goals that ultimately relate to the bottom-line performance** of the organization; and
- Intel is wary of setting goals that are relative to its peers, as many of the associated relative metrics can be irrelevant to the company's ultimate ESG or financial performance.

Case Study 3

Company Name: National Australia Bank Limited

Sector: Financials

Country: Australia

Introduction

National Australia Bank Limited (NAB) provides financial services, advice and products with operations in Australia, New Zealand, Asia, the United Kingdom and the United States. The company states that it sees corporate responsibility as illustrative of its values and has therefore integrated its corporate responsibility initiatives into its business strategy. NAB makes a conscious effort when identifying the materiality of ESG metrics used for remunerative purposes and in identifying which metrics are most aligned with its business story and overall compensation philosophy. The global crisis in the financial sector has made sustainability performance less of a critical issue for many investors; however, NAB states this has not diminished its focus on material and appropriate ESG performance measures.

The ESG metrics used by NAB contain 5 key elements: customers; people; community; environment; and supply chain. At the heart of their approach is the notion that in order for the bank to be sustainable and operate in the long term, a customer-centric focus and a desire to ensure fair access to banking, good products and services, transparency, dealing with those in hardship and availability of microfinance programmes is required.

NAB also has a focus on its employees and how they deliver on the customer proposition, by ensuring that the bank is an excellent workplace, implements fair remuneration, and provides appropriate training and development programs. In 2010, NAB moved to an integrated reporting strategy in order to bring together material information about their operating environment, business strategy, governance, financial and non-financial performance, and better articulate how they create and sustain value for their stakeholders.

While it does not have a board level committee that is dedicated to ESG issues, every director is charged with ensuring good corporate responsibility. NAB also has a Corporate Responsibility Council (chaired by the Executive Director Finance and consisting of the Australian members of the Group Executive Committee) that receives feedback from external as well as internal councils that represent specific issues such as diversity, customers, and indigenous peoples.

NAB establishes materiality of ESG indicators through a series of stakeholder engagement meetings and workshops in order to understand what external stakeholders think are important factors for the company. NAB then maps what it believes to be important aspects of corporate responsibility across the priorities of its stakeholders in order to develop a Corporate Responsibility scorecard consisting of key performance indicators. In 2011, NAB identified a number of metrics that were amalgamated into the company's performance summary as well as its corporate responsibility scorecard. The corporate responsibility scorecard currently incorporates several key areas including: customer satisfaction; customer complaints; growth of microfinance loans; diversity; staff turnover; staff engagement; carbon emissions; and supply chain contracts that meet NAB's sustainability principles.

Achievement of the corporate responsibility

scorecard is included as a performance measure in every Australian-based senior executive's scorecard. NAB incorporates all indicators into every executive's scorecard in order to ensure they are accountable for issues related to corporate responsibility. The executive's overall achievement against the performance scorecard directly links to his/her annual short-term incentive. NAB sets the level of target incentive so that it provides a meaningful proportion of the executive's total remuneration and ensures they are focused on delivering on the company's strategy, including the key corporate responsibility indicators.

For example, one of NAB's key ESG considerations is diversity. As such, the CEO has several diversity metrics that are linked directly to the CEO's scorecard. These metrics include: raising the proportion of subsidiary board positions held by women from 14 per cent to 30 per cent by 2015; increasing the number of women in senior ranks (the top three layers of the organization) from 23 per cent to 33 per cent by 2015; strengthening the talent pipeline by creating a 50/50 gender balance in graduate program intake and ensuring even representation of both women and men on core talent development programs from 2011; and aiming for the number of female non-executive directors on the Board of Directors of the company to reach 30 per cent.

Key Takeaways:

- NAB uses **stakeholder engagement to determine appropriate metrics** upon which to base its corporate responsibility strategy as well as the ESG metrics to form a corporate responsibility scorecard;
- The **corporate responsibility scorecard** is incorporated into senior executive performance scorecards and the **assessed outcomes directly influence their short-term incentives**; and
- **All of NAB's key corporate responsibility indicators are woven into the performance scorecard applicable to Australian based senior executives** in order to ensure accountability and focus on key issues that ultimately drive the company's corporate responsibility strategy.

2: Linking ESG Metrics to Executive Pay

Recommendation II: Companies should link appropriate ESG metrics to reward systems in a way that they form a meaningful component of the overall remuneration framework.

Guidance Point 2.1

ESG targets should be integrated into an appropriate time horizon that is in line with business strategy.

Companies and compensation committees should design plans that appropriately incentivize executives toward specific behaviors relevant to each company's unique context. Whether ESG-linked targets are tied into long-term or short-term incentives will depend on a company's strategic goals, economic environment and compensation philosophy.

Most companies that currently link compensation to ESG factors do so through short-term incentives. Short-term incentives are usually based on factors such as individual performance, annual or quarterly goal completion and short-term financial performance, and often leave room for a variety of metrics upon which executives can be rewarded. Conversely, long-term incentives are usually tied to fewer metrics (often financial), such as a company's total shareholder return or earnings per share. However, ESG metrics would be particularly suited as proxies for a company's long term success. Companies are therefore encouraged to consider including ESG targets in long-term incentive plans to ensure alignment with long-term strategies.

Guidance Point 2.2

ESG targets should be stringent and challenging to ensure incentivizing outperformance.

Regardless of the metrics used, it is crucial that companies reward executives for their contribution to a company's success and withhold payments when executives fail to meet goals or contribute to a company's underperformance. Due to the ambiguous disclosure of ESG metrics in many compensation plans, investors have grown concerned that these metrics are not effectively linking compensation to company performance.

By considering measureable ESG metrics, companies are better able to ensure that compensation can be awarded based on relative performance of such metrics when appropriate. While absolute goals may suit some circumstances, certain ESG metrics could be measured compared to peers as relative achievements and still provide challenging goals and potentially lead to sector outperformance. Metrics may vary between years, however companies should be able to chart clear goals with measurable outcomes, allowing investors to compare a company's current and former progress towards its goals.

Guidance Point 2.3

Companies should select appropriate mechanisms and structures when creating incentive pay packages to ensure long-term shareholder value creation.

Compensation packages should take into account individual and corporate financial performance, including ESG performance. By creating suitably structured compensation packages based on an appropriate portfolio of incentive-based metrics (i.e. a balanced scorecard approach), companies can better ensure long-term shareholder value creation. By constructing a portfolio of appropriately selected metrics, compensation committees can successfully incentivize desired behaviors. This would ensure a broad-based focus on performance and minimize the risk of overpayment for mediocre or unsustainable results.

Executives should also be remunerated considering a principle of inter-conditionality. If executives do not meet their financial performance targets, they should not receive awards or their awards should be downsized appropriately. Similarly, executives cannot focus exclusively on the financial aspects of their performance, as ignoring ESG-driven targets can ultimately lead to severely negative long-term shareholder returns. While there may be times where an ESG initiative requires upfront costs, these costs should be seen within their context of long-term sustainable success, like any investment.

Companies should also utilize other mechanisms available such as gatekeeper conditions, modifiers or claw backs, as discussed in the following guidance point.

Guidance Point 2.4

Incentive compensation should be subject to downward discretionary adjustments by the compensation committee to account for unusual events or unintended consequences as well as claw-back provisions.

By applying modifying mechanisms to executive compensation, boards can ensure that executives are properly incentivized to take precautions and mitigate potential risks. For example, board discretion or formulaic measures should be used to reduce or eliminate executive awards based on optimal safety and risk management factors when events such as fatalities or catastrophic accidents occur.

Additionally, just as many compensation packages are subject to claw back provisions for rewards based on financial performance in the event of restatements or fraud, rewards for ESG performance should also be subject to claw back provisions in cases where it later becomes clear that such awards were not appropriate. For example it should be possible to claw back an executive's award if the executive is rewarded based on safety metrics and the company later suffers from a major incident that resulted from insufficient oversight or improper attention to safety measures.

Guidance Point 2.5

In quantifying ESG metrics and measuring performance, the board may apply a clearly substantiated degree of discretion.

Compensation committees may need to exercise discretion in allocating incentive awards to executives, as strict performance formulas may not always reflect the performance of a company and the individual accomplishments of executives. However, entirely or mostly discretionary award determination processes undermine the link between pay and performance and result in lack of transparency. While the board should retain some flexibility in order for incentives to be effective, pay must ultimately be clearly tied to corporate performance. Thus, boards should incorporate a minimum level of objectivity into employee incentive plans and limit the opportunities to exercise discretion to vary payout levels in response to extraordinary circumstances and nonrecurring events. By limiting discretion, boards can ensure that executives are held financially accountable for their performance relative to ESG goals. In cases where discretion has been applied, the board should clearly substantiate its final decision.

Case Study 1

Company Name: Eskom

Sector: Utilities

Country: South Africa

Introduction

Eskom is wholly-owned by the South African Government and produces approximately 95 per cent of the electricity used in South Africa and approximately 45 per cent of the electricity used in Africa. As a public utility, Eskom is exposed to various operational risks related to sustainability factors and therefore incentivizes its employees to mitigate those risks through ESG metrics that are tied to both their long- and short-term compensation packages.

Eskom has been incorporating ESG metrics in its remuneration packages since the 1980's, and has refined them over time. The company incorporates ESG metrics in both long and short-term incentive packages and has set up several mechanisms to facilitate this process. For example, Eskom uses annually defined "gatekeeper conditions," to trigger operational governance reviews if the conditions are not met.

Eskom's long-term incentives incorporate ESG metrics that comprise 10 per cent of the total long-term incentive value and are directly correlated to key performance indicators linked to its annual Shareholder Compact.[1] Long-term incentives are only granted to executives, and are based on three-year targets established by the board's remuneration committee. These incentives focus mainly on the avoidance of environmental contraventions, such as compliance with legal requirements regarding Eskom's water usage.

Short-term incentives include metrics such as emissions, water utilization, internal energy efficiency and demand-side management.[2] ESG metrics comprise approximately 50 per cent of total short-term incentive-based pay, and are broadly applicable throughout the organization. The short-term incentives are subject to modification based on incidents such as fatalities, overdue or significant fines, contraventions of legislation or on measures of the company's reputation. Any incidents that qualify for incentive modification will cause a 6 per cent reduction in remuneration. Eskom's focus on modifying events has caused the company to emphasize several ESG targets while also leading to organizational benefits. For example, an increased focus on safety and mitigation of corresponding risks has led the company to ensure all incidents are reported. This focus has created an organizational awareness on zero-harm targets and has decreased the rate and intensity of accidents within the organization.

1. The Minister of Public Enterprises is the shareholder representative of the South African Government and has oversight responsibility for Eskom. This relationship is governed by a shareholder compact. The shareholder compact sets and agrees on Eskom's strategic intent, key performance areas and targets. The compact includes strategic objectives, policies, financial, technical and other key performance indicators and reporting requirements, as well as ESG targets that flow into performance packages for executives.

2. Planning, implementing and monitoring activities to encourage consumers to use electricity more efficiently, including both the timing and level of electricity demand

Over the last 20 years, the company's ESG metrics have been driven and defined primarily by legislative initiatives. Specifically, as particulate emissions and water utilization have come to the forefront of public debates in South Africa, the company has responded by incentivizing its workforce to work to drive down Eskom's emissions and water usage. Additionally, because Eskom is wholly-owned by the South African government, it is held to a higher disclosure standard. Executive remuneration, including performance against ESG targets, is reported in the company's annual integrated report. Furthermore, the company's reputation as a well-governed company with a focus on ESG issues has led Eskom to experience benefits regarding its reputation and human capital. The firm states that despite relatively conservative remuneration, it has attracted and retained quality employees who have taken an interest in Eskom's business and believe that by working for the company they are able to make a positive change.

Key Takeaways:

- Eskom has established key performance indicators that are tied directly to its ESG metrics;
- Eskom uses both **long- and short-term incentive packages that incorporate ESG metrics**;
- The firm's long-term incentives typically contain 3-year ESG targets;
- The company's **compensation packages contain modifiers to ensure that there is an emphasis on mitigating potential risks**; and
- Eskom's focus on ESG issues has allowed it to reap the benefits of attracting and retaining a qualified and dedicated workforce, despite limitations on remuneration.

Case Study 2

Company Name: BHP Billiton

Sector: Basic Materials

Country: Australia

Introduction

BHP Billiton is a diversified natural resources company that produces or extracts petroleum, aluminum, base metals (including uranium), diamonds and specialty products, stainless steel materials, iron ore, manganese, metallurgical coal and energy coal. Given the potential ESG-related risks faced by the company, BHP Billiton has embedded sustainability within its entire organization, with particular reference to health, safety & the environment. The company has been progressively evolving its practice of integrating ESG metrics in its remuneration packages, as evidenced by its remuneration report disclosure. While BHP Billiton has used safety (measured predominantly by injury frequency rates) as a driver of executive remuneration for many years, over the past two years BHP Billiton has established a balanced scorecard approach to ESG metrics as a basis for executive remuneration. The oversight functions of both the sustainability committee and the remuneration committee of the board are utilized in order to assess and reward executives on their ESG performance.

While some companies need encouragement to incorporate ESG factors into their remuneration structure, BHP Billiton has embraced the incorporation of these factors into its remuneration packages. This is due to the fact that BHP Billiton believes that ESG issues are integral to the mining sector, and as such, the company understands that ignoring ESG issues could ultimately result in the loss of its license to operate in particular areas of the world. BHP Billiton recognizes that any diminution in or loss of its license to operate will negatively impact its ability to execute its strategy of creating long-term shareholder value through the discovery, acquisition, development and marketing of natural resources.

Due to the potential impact of ESG factors on the company's operations, BHP has embraced the incorporation of ESG metrics into its remuneration packages. The company has seen an overall progression in its incorporation of these metrics and it has put in place a structure whereby the sustainability committee of the board receives a detailed paper on the Health, Safety, Environment and Community performance of the company. Based on this paper, and after reaching a view of what entails appropriate outcomes, the sustainability committee advises the remuneration committee on its assessment. The remuneration committee typically pays close attention to the sustainability committee's assessment of the company's performance, and a focus on the growing relationship between these two committees has been a key part of BHP Billiton's evolution in improving its governance and its metrics setting processes.

Currently, 15 per cent of executives' short-term incentives are based on a balanced scorecard of ESG measures. At present, BHP Billiton's long-term incentive plan is based on total shareholder returns, and ESG metrics are not explicitly included. The company currently takes this approach as it believes ESG performance has the potential to have a significant impact on overall financial performance in both the short and long-term. Poor

ESG performance will therefore be reflected in total shareholder return, thereby influencing the vested outcomes of the long-term incentive plan.

However, BHP Billiton's remuneration structure has recently undergone significant changes. For example, in 2009 and 2010 ESG metrics were primarily focused on total recordable injury frequency; however, since 2011 the company has adopted a balanced scorecard approach for its ESG metrics which were broadened to include fatalities, significant environmental incidents, HSE risk management, human rights impact assessment, and environment and occupational health. The remuneration committee also has the discretion to award zero pay-outs in the case of extreme events, regardless of the outcomes of its formulaic measures. The company has seen continued progress over time in its sustainability initiatives and states that linking ESG issues to remuneration has had a significant financial impact on employees whose compensation is most closely linked with ESG measures, driving better ESG performance. This has coincided with BHP Billiton's broader initiative of minimizing operational risk.

Key Takeaways:

- There are clear lines of oversight at BHP Billiton and the sustainability and remuneration committees of the board work in conjunction to establish and verify appropriate ESG metrics to be used for the purposes of executive remuneration;
- The collective efforts between the sustainability and remuneration committees of the board has assisted BHP Billiton in establishing more robust governance practices;
- BHP Billiton uses **a balanced scorecard approach to ensure that both ESG and financial goals are achieved** within the organization;
- The **board retains discretion** in awarding remuneration based on ESG metrics **and can reduce payout levels based on underperformance or certain qualifying events**, despite their formulaic approach to determining awards; and
- BHP Billiton associates **higher levels of performance related to sustainability initiatives** due to properly incentivizing executives on ESG metrics.

Case Study 3

Company Name: DSM

Sector: Chemicals

Country: The Netherlands

Introduction

DSM is a chemical group primarily engaged in the life and materials sciences, operating through four divisions: nutrition, pharma, performance materials and polymer intermediates. The company has identified sustainability as its one core value, directly related to its mission to create "brighter lives" for people today and generations to come. Based on this core value, DSM's business principles are focused in three areas: People (social and humanitarian standards), Planet (environment) and Profit (principles regarding fair and ethical business practices). Additionally, DSM's remuneration policy reflects a balance between the interests of all main stakeholders and the company's strategy, with pay packages designed to combine short-term operational performance with the medium and long-term objective of creating sustainable value within the company.

In 2010 DSM redesigned their remuneration policy to ensure further alignment with corporate strategy and values. In addition, some of the changes made were necessary to comply with the amended Dutch corporate governance code. Key points of the revised policy included: improved simplicity and transparency; focus on medium and long-term value creation for stakeholders; and variable components of remuneration based on predetermined and measurable value-creating performance criteria, predominantly of a long-term nature (inclusion of ESG metrics in the long-term incentive plan).

Additionally, DSM also set a number of sustainability aspirations for 2015, relating to innovation and operations (ECO+ products[3]), energy efficiency, greenhouse gas emissions, employee engagement, diversity, and receiving a top ranking at the Dow Jones Sustainability Index. Clear targets were set and disclosed, and the 2011 integrated Annual Report discloses on progress towards all these aspirations.

Executive pay at DSM is equally composed by fixed salary and variable remuneration. The Short-term Incentive scheme (STI) accounts for half of variable remuneration, while the Long-term Incentive scheme (LTI) accounts for the other half. Sustainability aspirations clearly linked to remuneration include: ECO+ products; energy efficiency; employee engagement survey; and greenhouse-gas emissions.

According to the company, the STI scheme has been designed to reward short-term operational performance aligned with the long-term objective of creating sustainable value, taking into account the interests of all stakeholders. Fifty per cent of

3. ECO+ solutions are products and services that, when considered over their whole life cycle, offer clear ecological benefits (in other words, a clearly lower eco-footprint) compared to the mainstream solutions they compete with. These ecological benefits can be created at any stage of the product life cycle – from raw material through manufacturing and use to potential reuse and end-of-life disposal. ECO+ solutions, in short, create more value with less environmental impact. The qualification ECO+ is based upon internal expert opinions where various impact categories are evaluated. For a growing number of products these expert opinions are supported by Life Cycle Assessments.

the STI is based on financial metrics, 45 per cent on sustainability metrics, and five per cent on individual non-financial metrics. STI metrics linked to sustainability include:

- ECO+ products (percentage of successful product launches that meet ECO+ criteria)
- Energy-efficiency improvement[4] (linked to target of 20 per cent increase in energy efficiency in 2020 compared to 2008)
- Employee Engagement Index[5] (related to the High Performance Norm in industry[6])

DSM does not disclose the actual targets, as they are considered commercially sensitive information. However, the company states that target setting and achievement are audited by external auditors.

Additionally, the integrated Annual Report clearly discloses progress towards meeting aspirational targets. In 2011 the percentage of ECO+ solutions in the innovation pipeline was 94 per cent, well above the initial target set. ECO+ solutions as a percentage of running business increased to 41 per cent, well on its way towards meeting half of their initial target. The report also mentions that DSM is on track with its drive to improve energy efficiency: the initial target consisted of a total increase of 20 per cent between 2008 and 2020, and in 2011 energy efficiency had already improved by 13 per cent (compared to 2008). Finally, in 2011 DSM executed its fourth worldwide Employee Engagement Survey. The main element in the survey was the measurement of DSM's Employee Engagement Index, the percentage of employees scoring favorable on a combination of four attributes: commitment, pride, advocacy and satisfaction. The Employee Engagement Index measured in 2011 again was close to High Performance Norm with an all-time high response rate of 91 per cent.

Fifty per cent of the LTI is based on financial metrics, and 50 per cent on sustainability metrics. The sustainability metrics include: Comparable Total Shareholder Return (TSR) performance versus a peer group and Greenhouse-gas emissions (GHGE) reduction over volume related revenue.[7]

Performance shares granted vest based on the achievement of fully disclosed targets for both TSR and GHGE, measured over a 3-year period. In addition, during 2011 DSM introduced claw-back provisions in the LTI rules; however, details of these provisions are not included in the Annual Report.

Key Takeaways:

- DSM has established **ESG metrics tied directly to corporate strategy and values**;
- The company has provided a **strong and meaningful link between key ESG metrics and executive pay**;
- DSM has designed a **bonus plan that aims to reward short-term operational performance aligned with the long-term objective of creating sustainable value**;
- DSM incorporates ESG metrics into both its **long- and short-term incentive packages**; and
- There is clear disclosure of targets related to the ESG aspect of the long-term incentive plan.

4. Company definition of Energy-efficiency improvement: "Reduction of the amount of energy that is used per unit of product (known as energy efficiency) on a 3 year rolling average basis"

5. Company information on Employee Engagement Index: "An Employee Engagement Survey is conducted annually, focusing on a combination of perceptions that have a consistent impact on behavior and create a sense of ownership. Research has consistently shown that the four key elements (satisfaction, commitment, pride and advocacy) define engagement and link engagement to business performance metrics."

6. Company definition: High Performance Norm (79 per cent favorable) is the composite of the top 25 per cent employee responses of the selected external benchmark organizations.

7. The company provides the following information: "The definition of greenhouse gases (GHG) according to the Kyoto Protocol includes carbon dioxide (CO_2), methane, nitrous oxide (N_2O), sulfur hexafluoride, hydrofluorocarbons and perfluorocarbons. The scope for calculation of GHGE reduction is as follows: (I) DSM's direct emissions (on site or from DSM assets) mainly comprise CO_2 and N_2O (scope 1). (II) DSM's indirect emissions (emissions created on behalf of DSM in the generation of electricity or the delivery of energy via hot water or steam) relate to electricity from the grid. DSM relies on local suppliers (scope 2). (III) DSM does not report in detail on scope 3 emissions (catch-all for remaining emissions that result from activities of the company (e.g. business travel)"

3: Linking ESG Metrics to Executive Pay

Recommendation III: Companies should endeavor to disclose the rationale, method and challenges presented by the incorporation of ESG metrics into executive pay clearly and concisely

Guidance Point 3.1

There should be clear disclosure of the rationale in identifying ESG metrics linked to executive compensation and evidence of alignment with business strategy and shareholder value.

When companies decide to include ESG metrics in executive pay, they should provide as much information as possible regarding the rationale. Companies should also disclose both the rationale behind granting awards based on financial or ESG metrics and the extent the executive's performance led to an increase or protection of shareholder value, thereby providing justification for awards to individual and business unit accomplishments.

Additionally, companies are encouraged to explain why the chosen ESG metrics should be viewed as aspirational and rigorous, and how they contribute to value creation. This approach ensures that the practice of including ESG metrics in compensation packages does not become "another way to pay" executives.

Guidance Point 3.2

Disclosure of metrics and performance targets should be understandable and there should be clear and concise information regarding the structure and mechanisms used in linking ESG metrics to compensation.

It is not necessary for companies to disclose every detail of how ESG metrics relate to compensation; however, companies should provide investors with meaningful and clear information on how ESG metrics have been identified and considered into decisions regarding executive compensation. This allows investors to understand how executives are being compensated based on ESG metrics and assess if awards are justified, in the interests of the company, or under the executive's control. Clear disclosure by companies will also provide them with an opportunity to externally communicate the values they espouse, their commitment to ESG-related issues, how they factor ESG metrics into their overall business structure and the efforts they have taken to mitigate long-term risks and prioritize long-term value creation. How a company discloses its executive compensation and what factors they disclose is representative of the public commitment it makes to its shareholders and stakeholders.

Concise and clear disclosure by companies ensures that investors are better able to ascertain the structure and mechanisms by which compensation is assessed and awarded. As many countries are adopting more stringent requirements regarding executive compensation disclosure, it is imperative that companies clearly lay out how ESG metrics are incorporated into compensation packages so that investors can easily understand and comprehend these metrics' place, weighting and importance in a company's compensation philosophy. If information is vague, hidden or couched in language that is not easily understood by a broad investor base, the company's efforts to include this disclosure may be for naught.

Guidance Point 3.3

Disclosure should provide sufficient information to allow investors to assess performance against ESG goals.

In addition to providing disclosure regarding metrics and targets, the disclosure of actual performance and past performance relative to those targets is encouraged to allow investors to better understand how a company is mitigating sustainability risks and realizing ESG-related opportunities.

However, it is also recognized that full disclosure against targets may not be appropriate in all circumstances. While companies should not disclose information that may be detrimental to their interests or place them at a competitive disadvantage, some disclosure regarding ESG metrics and relative performance is warranted due to the fact that companies are using corporate and shareholders' funds to remunerate executives.

Mechanisms used as modifiers related to ESG performance should also be considered when companies are disclosing compensation information. By disclosing information on claw back or zero harm policies, companies allow investors to better assess how executives have been held accountable and incentivized to ensure long-term performance.

Guidance Point 3.4

Disclosures of relevant ESG goals and their associated links to compensation should be integrated into official pay disclosures.

Disclosure of how companies make a link between compensation and ESG metrics should be made through official filings, such as proxy statements, management information circulars and reports and accounts. By placing this information alongside more traditional and required compensation discussions, companies allow investors to grasp the entirety of a company's compensation philosophy and assess its effectiveness relative to performance. Companies able to clearly communicate ESG performance indicators alongside more traditional performance indicators can better explain how compensation is broadly perceived, and formalize their interpretation of ESG metrics into their overall compensation structure. As many investors cast votes on resolutions regarding companies' compensation packages, it is important that they are given full information about what factors drive said compensation so that they are able to accurately gauge those companies' values, goals strategies and priorities.

Case Study 1

Company Name: Alcoa

Sector: Materials

Country: United States

Introduction

Alcoa is engaged in the production and management of aluminum, and operates in four segments: alumina, primary metals, flat-rolled products, and engineered products and solutions. Alcoa has operations primarily in the United States, Australia, Spain, Brazil, the Netherlands, Norway, France, the Russian Federation, Hungary, Italy, the United Kingdom, China, and Germany. Alcoa has a very visible commitment to sustainability, with a scorecard developed in 2010 to align its sustainability targets with its broad business strategy and measure its progress against key short-term ESG metrics.

When former CEO Paul O'Neill was brought into Alcoa in 1987 he was singularly focused on employee safety and reducing injury rates. This focus is still present in Alcoa's remuneration structure, where safety and other ESG metrics have been publicly-disclosed as performance indicators in executive compensation packages for many years. For its 2008 pay packages, Alcoa broadened its ESG indicators to include diversity, which represented 10 per cent of the total target award for each business unit. Further, Alcoa stated that in addition to safety and diversity goals, "each business unit had up to five non-financial goals chosen by each business unit, such as productivity, delivery performance, quality and other metrics specific to a particular business or plant".[8] Alcoa narrowed these indicators the following year: in 2009, the company's annual incentive plan included a 10 per cent weighting each for safety and diversity. It stated that "[i]improving the safety of our workplaces has long been a goal of Alcoa and we rank among the leaders in industrial companies on safety statistics. As in the past, we have included a 10 per cent weighting in our annual cash incentive plan for improving safety statistics to continue our progress in this important area. We also included a 10 per cent weighting in the annual cash incentive plan for improving the representation of women and U.S. minorities in professional and managerial ranks. We believe that providing a cash incentive for achieving improvement in the representation of women and U.S. minorities will help to increase representation of those groups in our professional and managerial positions, which will contribute to the diversity of our company".[9]

In 2011, Alcoa significantly increased disclosure related to its ESG metrics. While it maintained a similar incentive structure as the prior year (with ESG objectives representing 20 per cent of incentive compensation, diversity representing 10 per cent, carbon emissions reductions representing 5 per cent and safety representing 5 per cent), Alcoa greatly increased the amount of information given to investors about both the targets themselves and executives' performance relative to the targets. For example, in 2011 Alcoa provided the 2009 actual measurements and the 2010 targets and results, as well as their respective weightings and payouts.[10] In its 2012 proxy statement, Alcoa further defined its

8. 2009 DEF 14A, p. 26
9. 2010 DEF 14A. p. 27

safety goals as including both the Total Recordable Rate of injuries as well as a Global Voices Survey on Safety questions. Along with its previous diversity and environmental goals, the company disclosed its target performance, its actual performance, the incentive compensation result, the weighting of these factors, its formula awards and other detailed information about its ESG metrics.[11]

Alcoa further states on its website that in order to ensure the integration of sustainability to core business strategies, the CEO has championed the linkage between pay for performance and the achievement of specific sustainability objectives. Alcoa further states that this linkage is widely applicable and that remunerative targets focused on improvements in energy intensity, diversity and safety are applied in some form across the entire workforce.

Alcoa's Public Issues Committee, amongst other responsibilities, is charged with oversight of ESG metrics. These include: providing oversight of the company's policies and procedures on sustainability and social issues; making recommendations to the board on significant stakeholder concerns or proxy proposals involving the environment, sustainability, social responsibility or other public issues that may have an effect on the reputation of the company; identifying and bringing to the attention of the board as appropriate, current and emerging political, social and environmental trends and public policy issues that may affect the business operations, performance or public image of the company.

Key Takeaways:

- Alcoa has **clearly defined and easily understood disclosure of ESG criteria** that it links to executive compensation;
- The company has several narrow metrics to which it links to compensation across the entire workforce;
- Alcoa makes **clear disclosure of its ESG metrics and executives' associated performance against those metrics in its annual proxy filings**; and
- There has been a steady, **visible evolution of Alcoa's link between ESG factors and compensation**.

10. 2011 DEF 14A, p. 24
11. 2012 DEF 14A, p. 29

Case Study 2

Company Name: Agrium, Inc.

Sector: Materials

Country: Canada

Introduction

Agrium is a global producer and marketer of nutrients for agricultural and industrial markets, with operations in North and South America as well as Australia. Agrium produces and markets three primary groups of nutrients: nitrogen, phosphate and potash as well as controlled-release fertilizers and micronutrients. As Agrium maintains mining and processing operations, which carry significant environmental and safety risks, it is important that the company ensures that associated risks are properly mitigated in order to reduce impacts and associated fines.

For example, in Agrium's 2009 Sustainability Report, the company states that its environmental fines and penalties totaled C$830,507 in 2009, down from C$1,119,928 in 2007 and its environmental remediation liabilities totaled C$140 million in 2009, up from C$69 million in 2007.[12] Because of the bottom-line impacts of its health, safety and environmental performance, it is important that Agrium incentivize the mitigation of environmental and safety risks. According to its 2009 Sustainability Report, Agrium "routinely set[s] internal targets, not just for financial performance but for sustainability issues as well. For example, to encourage uncompromising safety performance Agrium "includes safety performance in the compensation calculation of senior management (directors to CEO)" .[13]

Since 2009, Agrium has stated in its proxy circulars that "company strategy achievements, including (i) industry leadership growth, (ii) employee health and safety, and (iii) creation and sustenance of high performance culture" and the promotion of "adherence to high ethical, environmental and health safety standards" are several objectives of its compensation program.[14] Agrium ties these elements to its compensation programs through a scorecard approach with multiple performance goals to determine incentive payouts. Agrium also links executive compensation to sustainability metrics through its Performance Recognition Plan, which "focuses on the achievement of objectives at the corporate, business unit and individual level, including achievement of Agrium's key performance indicators." [15]

For at least the past four years, Agrium has maintained a performance goal of improving "measurable safety and environmental indices, including reduction of employee and contractor total recordable injuries and reduction in environmental events."[16] Agrium has included this performance goal, which is 15 per cent of its Performance Recognition Plan in order to improve its "core business and increase competitiveness."[17] Additionally, performance below a defined

12. 2009 Sustainability Report, p.39
13. 2009 Sustainability Report, p.11
14. 2009 Management Circular, p. 34, 2010 Management Circular, p. 39, 2011 Management Circular, pp. 37-38, 2012 Management Circular, pp. 42-43
15. 2012 Management Circular, pp. 45
16. 2012 Management Circular, p. 57
17. 2012 Management Circular, p. 57

threshold can result in a zero-out of Performance Recognition Plan incentive payouts and the board maintains discretion over compensation, which it has used to lower payments based on performance relative to environmental, safety and health issues.

The Company has annually listed its sustainability-related goals and well as its performance relative to those goals. For example, in its 2008 and 2009 proxy filings, Agrium achieved target level results for the reduction of total recordable injuries and exceeded expectations in reducing the occurrence of environmental events.[18] In 2010, Agrium stated that it achieved slightly above target level results across safety and environmental indices.[19] Further, in 2011, Agrium partially achieved its safety and environmental goals by setting aggressive Environment, Health, Safety and Security targets representing continuous year-over-year improvement, exceeding its target level goal for employee total recordable injury rates and lost time, and exceeding its maximum level goal with excellent results for its measure of environmental incident rates. However, Agrium experienced an employee fatality and a contractor fatality in 2011, which caused the board to exercise downward discretion in respect to compensatory awards.[20]

Agrium also lists annual performance objectives and performance against such objectives for the given year, including (if applicable) descriptions of business unit performance goals for which the executive is responsible. While these goals are not directly linked to a discussion of executive compensation, shareholders are able to measure individual executives' achievement of corporate performance goals, including health, safety and environmental goals.

Agrium's board-level Environment, Health, Safety and Security committee charter states that, on a quarterly basis, it reviews the company's environmental health, safety and security activities. Additionally, this committee reviews the audit plan for the upcoming year, which includes environment, health, safety and security compliance and system audits.

Key Takeaways:

- Agrium makes **clear, concise and easily understood disclosure** regarding its remunerative ESG metrics in its annual management information circular;
- The company discloses that it maintains discretion in executive compensation based on ESG metrics, and reports **how modifying events have affected compensation levels**;
- Agrium has consistently **disclosed that it uses ESG metrics** to determine executive compensation, and **why those metrics aid in its overall corporate strategy**; and
- Agrium maintains explicit board oversight of its health safety & environmental performance.

18. 2010 Management Circular, p. 51, 2009 Management Circular, p.45
19. 2011 Management Circular, p. 49
20. 2012 Management Circular, p. 57

Appendix A: Academic and Literature Review

1. Current practices from industry research

Research on current corporate practices by responsible investment networks and service providers indicate there is an overall increase in the number of companies that link ESG performance and remuneration.[21] Although this trend is generally promising, research shows these links are generally weak and there is still a significant lack of available data to assess companies' practices.

Only a very small percentage of global companies disclose clear and strong ESG targets included in their incentive structures. Generally, the percentage of incentives based on ESG performance is small and few companies consider ESG measures over a period exceeding one year. The majority of companies integrate ESG metrics in the cash annual bonus rather than in their long-term incentives.

There are also major challenges in effectively comparing companies' varying approaches to integrating ESG issues into executive remuneration. Environmental and social metrics are more commonly considered than governance indicators. Major differences between sectors can be observed; for example the process of integrating ESG issues into remuneration packages appears more advanced in the energy, utilities, and materials sectors. There are also differences within the same sectors across markets; for example, the percentage of best practices observed among North American companies appears to be significantly higher than in European companies.

Regulation seems to have direct impact on the use of ESG metrics, with some measures introduced to improve compliance with legislation requirements. On the other hand, more stringent regulation may decrease the necessity for voluntary adoption of ESG related incentives. Increased shareholder awareness and institutional investor best practice statements could also play a key role in inspiring the use of ESG metrics by companies.

Finally, research suggests that companies which strongly link ESG metrics to executive pay are more likely to have board oversight of sustainability issues.

2. Importance of linking ESG factors and executive pay

2.1 Competitive advantage

Although literature is not conclusive as to whether ESG factors can be a source of competitive advantage, there is increasing evidence that under certain conditions companies which adopt and implement ESG strategies outperform their peers. Eccles et al (2011) analyzed a harmonized sample of 180 US firms over the period from 1993 to 2010. Companies were divided in two groups: 90 companies were classified as High Sustainability firms, as they had already adopted sustainability policies on 1993; and 90 companies that had not adopted such policies were classified as Low Sustainability firms. Research found that sustainable firms generated considerably higher profits and stock returns, suggesting that in the long term developing a corporate culture of

21. Experts that provided relevant research include: **Glass Lewis, GMI Ratings, VBDO** and **Vigeo**

sustainability may be a competitive advantage for a company. In her study based on 157 German chemical firms, Delmas et al (2011) found that proactive environmental strategies positively impact firm performance.

In a series of meta-analyses, various authors have agreed that the majority of studies confirm the positive relationship between ESG and financial performance of companies (Gompers et al., 2003; Orlitzky et al., 2003; Allouche & Laroche, 2005; De Bakker et al., 2005; Van Beurden & Gossling, 2008). In 2011, the World Economic Forum also published a white paper listing research (conducted in the 2000s by Mercer, McKinsey, Innovest Strategic Value Advisors and the UK Environment Agency) showing the positive correlation between ESG factors and shareholder value creation. In addition, academic literature on the subject finds there is little evidence to suggest a negative relationship between the two dimensions (Post et al., 2002).

Several scholars seem to agree that monetary incentives linked to ESG factors have a positive impact on overall performance. Moreover, Russo and Harrison (2005) have studied the effect of tying environmental performance and remuneration on a sample of 169 U.S firms. The results reveal that monetary incentives for environmental performance appear to be efficient in motivating managers concerning ESG performance.

There is no set of data (financial or sustainability-related) that consistently correlates with firms' financial performance; however, it is becoming increasingly clear that sustainability performance does often affect financial performance. Under these circumstances, it is logical that ESG metrics are incorporated into executive pay to align manager and shareholder interests.

2.2 Reforms

Companies have also faced increasing pressure to reform executive remuneration systems. Until recently, executive remuneration has been almost singularly linked to financial metrics. Since the mid 1980's, the focus has been particularly on shareholder value creation (Jensen et al, 2004) with emphasis on incentives that are tied to stock options and stock grants. The purpose of this approach was to share the common interest of increasing the firm's value (Arantxa, 2008). However, several scandals contributed to rising concerns about existing CEO compensation systems and emphasized the need for transparency in remuneration practices.

Berrone (2008) argues that executive pay should include criteria addressed to the interests of all stakeholders rather than just shareholders (Berrone, 2008). A report from Eurosif (2010) highlights some interesting challenges and opportunities in linking ESG metrics and pay, such as compliance with new regulations and maintaining good shareholder and stakeholder relations. Since established ESG metrics integrate stakeholder interests, it is useful to consider how these metrics can be developed to meet the broader demands of remuneration reform.

2.3 Management support

Senior management has a significant impact on the corporate culture of a company. A number of studies have found that management support is a key element of adoption and execution of innovation in a business, particularly in the case of environmental initiatives (Delmas et al, 2011; Daily& Huang, 2001; Dechant & Altman, 1994). Berrone (2008) reported that if top managers are compensated for social performance this could cascade down to lower levels in the company and encourage a coherent social strategy of the company. Under these conditions, by tying executive remuneration and ESG issues, executives have incentives to improve ESG performance of the company and integrate these factors at every level of a firm.

Although aligning incentives with business strategy makes sense in principle, implementation is not necessarily straightforward. Management support is paramount in realizing the business strategy; research suggests that in practice, one challenge concerns the impact of the board on the decision-making process of the company and on the creation of incentives for employees. Coombs and Gilley (2005) studied the stakeholder management of 406 U.S firms, with the results revealing that CEOs seem to be given disincentives from the board for engaging in stakeholder value creation initiatives. Moreover, Atkins et al (2011) investigated risks that caused serious issues within 18 high profile corporate crises during the last decade. One of the causes identified is the inappropriate incentives and their effects on behavior. The study shows that board members need to act more effectively concerning risk management and in setting appropriate incentives for senior executives.

3. When does linking ESG factors and executive pay matter?

3.1 Business Strategy

Most scholars and practitioners agree that the remuneration system should be aligned with a company's overall strategy. Strategy defines the objectives a company would like to achieve by taking into account stakeholders' needs (amongst other factors). It provides overall direction for the activities of the firm and tries to define a common set of interests amongst the firm's stakeholders. The company approach to creating sustainable value is part of the overall strategy and has to be defined in harmony. Thus, ESG metrics would be expected to be embedded into the remuneration structure. One way to do that would be to develop a "remuneration philosophy" that reflects and is consistently loyal to the governing objective, the corporate vision and strategy. This conclusion is one of the 38 recommendations Jensen et al (2004) gave in their review.

There is evidence that ESG issues are related to long-term strategic issues. For example, after analyzing longitudinal data on 313 firms, diversified in terms of size, industry, and financial standing, Deckop et al (2006) reported that the way executive remuneration is organized has an effect on Corporate Social Performance (CSP). This study revealed that the greater the short-term focus on executive remuneration, the less the company's CSP, and conversely the greater use of a long term focus in executive remuneration, the higher the company's CSP.

Because strategy is so important in aligning employees' incentives with the long-term sustainable value of the business, a boilerplate approach to developing ESG metrics should be avoided. Cordeiro and Sarkis (2008) argue that companies should have a clear motivation for socially responsible actions in executive compensation systems in order to implement their business strategy effectively. Tonello (2011), in his note about "pay for performance", reveals the necessity for companies and directors to set objectives for pay leverage.

3.2. Industry specificity

As Berrone (2008) reports, stakeholders' needs differ by industry and geography. As each industry has unique and specific factors, companies need to take this into account while determining their strategy and policies. For example, several academic papers have focused on high-polluting industries where ESG incentives are relatively clear. Berrone and Gomez-Mejia (2009) found beneficial outcomes of linking executive compensation and environmental performance within polluting industries. Russo and Harrison (2005) investigated the impact of monetary incentives on environmental performance on a sample of electronics facilities. While their results are promising, the metrics in high polluting industries are relatively clear. Issues such as diversity and employee relations can be much more problematic even though they are topical in some settings.

A review from Vigeo Rating (2012) shows there is no clear overall trend concerning the process of linking ESG metrics and executive compensation. The review reveals that some sectors are more advanced than others in the integration process of ESG issues as a determinant of executive remuneration, such as macro-sectors including Energy & Utilities and Basic Resources. However, even within the same sectors, certain geographic areas are more advanced than others. The leadership of high polluting industries is reflected in academic research and other industry reports.

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