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# Incorporating ESG performance in board remuneration

A practical guide

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# Welcome

## Incorporating ESG performance in board remuneration

An effective Environmental, Social and Governance (ESG) strategy has rapidly gone from being a 'nice-to-have' to a necessity. Companies, investors and wider stakeholders increasingly recognise that ESG strategy will intrinsically be linked to future business resilience, and can positively impact many areas, from attracting talent and engaging employees to improving financial performance.

The actions of business executives are seen as critical in driving the ESG strategy. Although there are mixed views around the effectiveness of incorporating ESG metrics in board remuneration, it can be a powerful tool for driving leadership behaviours if structured in the right way, and linked to transparent and quantifiable performance metrics.

**A Remuneration Committee responsibility**

As with financial metrics, Remuneration Committees should ensure that they have enough flexibility to safeguard against rewards for failure, and seek external assurance around target-setting and performance out-turns. Where boards are demonstrably aligned with strategy and future business performance, the inclusion of ESG performance metrics can send an important signal to executives, employees, investors and wider stakeholders.

While many Dutch companies already have one or more ESG performance metrics in their executive incentive plans, we expect more companies globally to move toward linking incentive plans with ESG performance and, specifically, sustainability goals.

In this brochure, we provide concrete guidance on how to incorporate ESG performance in board remuneration.

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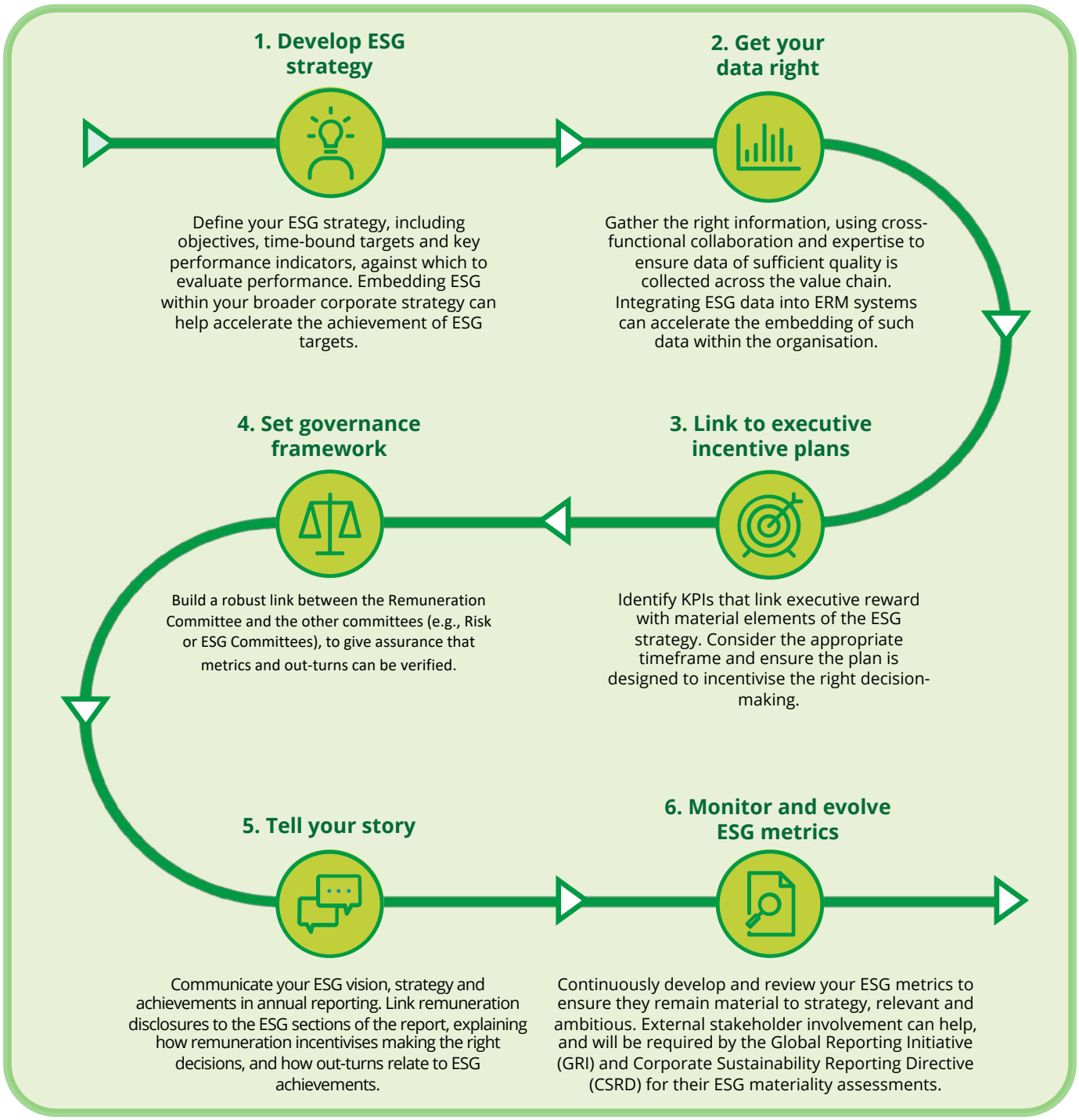
# Where to start?

## Guiding principles

Before incorporating ESG within the board remuneration framework, make sure that your company has an established ESG strategy with concrete goals. If the ESG conversation is started or led by the Remuneration Committee, it implies an absence of such groundwork.





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# Spotlight on monetising ESG impacts

## Every business seeks to create value, and the language of financial value is widely recognised and understood

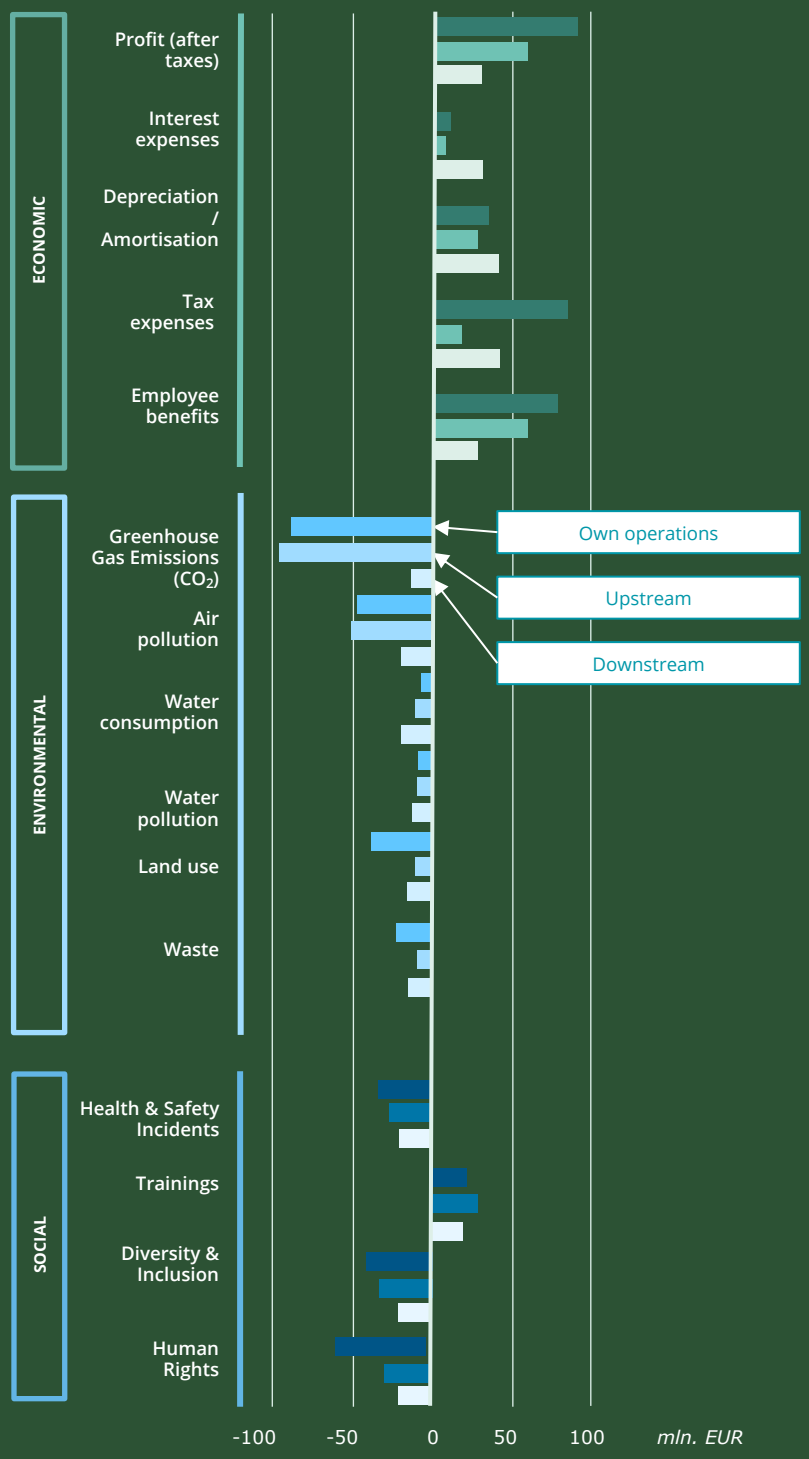
Historically, though, many social and environmental impacts have been expressed in a wide range of units, making them incompatible for comparison. To address this challenge, and deliver a comparable footing, impacts can be measured, quantified, and then converted into the same monetised units as conventional business results. Underlying this thinking is a more widely aligned concept of value and its beneficiaries: traditionally, these might be immediate shareholders and employees, but this type of approach also considers how such value is created or lost for the wider world.

Although existing ESG approaches might help in selecting and quantifying several environmental, social and governance indicators, some leading organisations in the ESG field identify and measure data that provides deeper insights into the impact they create for their broader stakeholders. In turn, that knowledge can be used to help them to identify the hidden risks and opportunities arising from their actions, and how they affect those stakeholders.

These organisations measure their impact across the whole value chain, in terms of three dimensions: environmental, social and economic. Within each, specific impacts can be measured, monetised and aggregated, to quantify each capital (see figure on the right).

Currently, only a limited number of organisations measure their impact in a monetised way. Others don't yet, for several reasons: lack of mature ESG reporting; ethical issues (e.g., compensating with economic value while destroying environmental value); absence of legislation and fully-developed standards. However, a growing number of organisations are using this approach, and some follow Value Balancing Alliance principles.

At Deloitte, we have developed our own Strategic Impact Assessment methodology. Find out **more**.





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# Key considerations for Remuneration Committees

Making the right decisions around ESG can be very challenging for Remuneration Committees and members' views between are not always aligned. Below are the most important considerations, which the following pages explore in more depth.

## 01 Design

How to incorporate ESG performance in executive remuneration?

## 02 Metrics

Which performance metrics to select?

## 03 Target-setting

How to set and track targets? How much flexibility should the plan include, to allow for any appropriate adjustments?

## 04 Disclosure and communication

How to disclose and communicate ESG metrics to stakeholders?


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# 01 Design

## How to incorporate ESG performance in executive remuneration?

### There are many ways to incorporate ESG performance in board remuneration, ranging from an underpin (lower impact) to a standalone incentive plan (greater impact)

Lower-impact plan designs could be appropriate when companies are first introducing ESG metrics and seeking familiarity with ESG measurement, but might not be perceived as material or meaningful. Designs with greater impact could have a stronger effect on executive motivations to take a longer-term view on ESG performance, but could be regarded as focusing too much on non-financials instead of financials.

In the Netherlands, nearly all AEX and AMX companies have incorporated ESG in their executive incentive plans, usually as a basket or scorecard, or standalone metric.

**Swapping time and performance?**

Long-term incentive plans are typically linked to performance realised over a pre-defined period (in the Netherlands usually three years). However, what might happen if we swapped time and performance, and based out-turn on the time taken to achieve pre-defined performance?

If, for example, the goal is to reduce CO2 emissions by 50% by 2030, traditional plans would typically set several interim targets for emissions levels. Alternatively, though, we can link the out-turn to the amount of time it takes to achieve the pre-defined performance. The sooner the goal is achieved, the higher the out-turn will be, e.g., maximum out-turn when the goal is achieved in three years, target out-turn when achieved in five years and threshold out-turn when achieved in seven years. Although the practical implications can create challenges, we increasingly observe companies exploring more innovative plan designs.

**Underpin**

Inclusion of ESG metric as prerequisite for any pay-out to happen, regardless of financial performance

**Modifier**

e.g. ESG modifier applied to incentive out-turn e.g. +/- 10%

**Basket or scorecard**

e.g. 4-5 ESG-related metrics assessed as part of scorecard

**Stand-alone metric**

Single 'material' KPI identified and linked to stand-alone incentive element (typically 10-20% weighting)

**Stand-alone incentive plan**

Separate incentive plan linked to ESG goals

**Design spectrum**

Lower impact ← → Higher impact


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# 02 Metrics

## Which performance metrics to select?

### Guiding principles from an investor perspective

The investor community sees ESG as both an investment risk and an opportunity and are updating their guidance on the use of ESG metrics in their guidance on executive remuneration.

> "These [sustainability] criteria should be **challenging** and **meaningful** in relation to the company's business"
>
> PGGM Investments

> "If the board decides to use ESG-type criteria, these criteria should be **linked to material issues** and they must be **quantifiable, transparent** and **auditable**. These criteria should **reflect the strategic priorities** of the company."
>
> Blackrock

> "ESG performance conditions may be used but targets should be **material** to the business and **quantifiable.**"
>
> ISS guidelines

Although some Remuneration Committees are feeling pressure to act and follow rapidly-shifting market practice, the main indicator for investors will be alignment with the wider strategic narrative, and any metrics should reflect the most material aspects of the ESG strategy. Consider where you are in your measurement journey, and your ability to track and measure outputs. From the range of metrics being used, investors will look at the extent to which incentive targets are quantifiable, transparent and verifiable.

### Current market practice

Approximately 80% of AEX companies analysed include an ESG metric in their annual incentive plan, and 55% in their LTI plan.

The most common metrics in annual incentive plans are social (employee engagement, diversity and inclusion, safety), but environmental metrics are increasingly being used. Environmental metrics, such as carbon emissions reduction or resource usage, are particularly common in long-term incentive plans.

**80%** **of AEX companies link the annual bonus (partly) to ESG**
Mostly Social measures

**55%** **of AEX companies link the long-term incentive (partly) to ESG**
Mostly Environmental measures

| Environmental | | |
|---|---|---|
| $CO_2$ emissions – scope 1 & 2<br>Carbon intensity<br>Vehicle fuel efficiency<br>Water efficiency | Recycling rate<br>'Green' financing<br>Plastic use<br>Renewable energy consumption | Hazardous waste<br>Biodiversity impact |

| Social | | |
|---|---|---|
| Digital education<br>Women in leadership<br>Community outreach<br>Fair tax policy | Accident / incident rate<br>Real living wage<br>Digital connections<br>Responsible supplier policy | Under-represented groups<br>Ethnic diversity |

| Governance | | |
|---|---|---|
| Cyber/ data security<br>Regulatory relationships<br>Risk management strategy | Conduct and complaints<br>Internal controls<br>Culture and engagement | Crisis management<br>Financial crime<br>Risk and ethics training |


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# 03 Target-setting

## How to set and track targets? How much flexibility should the plan include, to allow for any appropriate adjustments?

### The devil is in the detail

In many companies, the data quality, collection and monitoring systems for ESG performance are less mature and robust than those for financial performance. Often, ESG data is considered only retrospectively, rather than being an integral part of forward-looking budgeting or forecasting processes.

We expect organisations will step up their efforts to improve ESG data and processes, since upcoming CSRD regulations in the EU will require mandatory third-party external assurance on the information reported.

Beyond such reporting requirements and rapidly-evolving standards, you should consider other factors when calculating ESG data. For example, just as currency prices can impact financial performance, conversion factors (e.g., multipliers that turn business activity into carbon footprint) can change from year to year. It's therefore important to understand which data depend on external conversion factors, as these factors can affect the achievement of targets and therefore remuneration. Such target-setting is likely to involve input from sustainability, HR and finance functions, and possibly approval from the Sustainability Committee.

Companies have the choice whether to set targets on a binary basis, or across a range from threshold to maximum performance. The choice is likely to depend on weightings, plan design and how ESG goals have been articulated.

In the Netherlands, long-term incentive plans are increasingly linked to environmental performance, with three-year interim targets set by reference to longer-term sustainability and net zero ambitions, so it's important to consider the nature of the company's sustainability journey. For example, the journey to net zero might not be linear over a specific timeframe, which should be taken into account when setting interim targets.

### Allow flexibility for judgement and discretion

The ESG reporting landscape is changing fast, and Remuneration Committees should openly and transparently communicate how they plan to assess performance and progress, including areas where they anticipate a need for judgement and discretion. Plan documentation should incorporate the flexibility to allow for any appropriate adjustments needed to achieve like-for-like measurements at the end of the performance period. Many committees are seeking external verification of performance out-turns.

#### Science-based targets for sustainability metrics

**An increasing number of companies have disclosed that they have applied for, or already received approved of, sustainability goals under the Science Based Targets initiative (SBTi).**

**SBTi targets are favoured by investors, as their standards allow businesses to demonstrate that net zero goals align with the Paris Agreement and latest climate science.**

Beyond targets on CO2 emissions, science-based targets can also be used for other metrics, to take into account planetary boundaries and social floors.

Setting the right targets is challenging, as planetary boundaries and social floors are typically set at a global level and need to be translated to an organisational level to become useful and meaningful internally. Local context is important here: for instance, targets could take into account fresh water availability, local air quality and the living wage in a particular country or region.


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# 04 Disclosure and Communication

## How to disclose and communicate ESG metrics to stakeholders?

Communicating your ESG vision clearly can help you win stakeholder support. After establishing a method to monitor ESG topics (preferably in accordance with a standard framework), remuneration disclosures around ESG can be linked to the overall ESG vision.

Against the backdrop of improved disclosure of metrics used and target-setting, you must consider carefully what information will or will not be disclosed. Where it's not deemed commercially sensitive, sharing ESG ambitions prospectively (e.g., via disclosure of target-setting) can send a powerful message to stakeholders. To maximise your impact in this area, explore your available internal and external communication tools.

### Insights on assurance

We are seeing growing demand for assurance of ESG and sustainability information, although this presents some challenges:

- **Assurance providers** are many and varied, but all need to follow a professional framework that covers competence, independence and quality management, and is subject to oversight and a professional liability mechanism. Take time to understand who can best provide the assurance you need.
- **Assurance standards** are inconsistent. Today, ISAE 3000 is most common, but not used by all providers. Be mindful of which standard is being used and challenge your management team on anything you do not understand.
- **Scope** is frequently determined by management, but the decision is not always guided by risk, materiality or stakeholder interest. Focus on scoping your assurance to maximise consistency and validity.

The move to mainstream reporting of sustainability information will require significant long-term change. There are challenges here, too:

- **Long-term investment** and its integration into the core of the business model will require enhanced governance and robustness in a controlled environment. Significant funding will be needed.
- **Market immaturity** means that intangible factors present significant challenges around identifying which data to measure. Having clear criteria for selecting measurements is essential.
- **Connectivity** between ESG performance and financial performance is not always understood. Many extensive research has been conducted on the link between sustainability performance and financial results. We have found organisations that focus on their most material ESG topics outperform the market, but those that focus on all ESG topics underperform the market. It's therefore important to focus on factors that are material from a sustainability perspective, and ensure efforts are directed toward those. External assurance can also support by bringing a challenger view to a company's materiality perspective.


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# What's next?

As more and more organisations start on their ESG journey, the more mature organisations have already incorporated quantifiable, transparent and verifiable ESG performance metrics in their board remuneration.

Upcoming EU regulation and stakeholder pressure to improve ESG reporting and target-setting will lead more organisations to discover how incorporating ESG metrics in incentive plans can accelerate progress toward externally-communicated targets.

**Focus on performance outputs**
As companies increasingly develop science-based sustainability goals and improve their ability to monitor and measure ESG performance, we expect to see more focus on performance outputs, as well as clearer articulation of the link that connects ESG with business activity and opportunity.

**Quality of metrics and disclosure**
With ESG metrics becoming more prevalent, we see a shifting focus on the quality of metrics and disclosure. Following the recent announcement of the Taskforce on Nature-related Financial Disclosures (TNFD) consultation, we expect to see wider adoption of metrics on biodiversity and broader natural impacts. Longer-term, reporting that better connects financial and ESG performance could change the landscape in this area.

**We can help**
We understand the challenges around building ESG and sustainability into an organisation's purpose, strategy, goals and data, and can support you in this groundwork, as well helping you reflect these principles when designing your executive remuneration plans.

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