Evolving ESG metrics and employee compensation: The way forward

Board Leadership Center (India)

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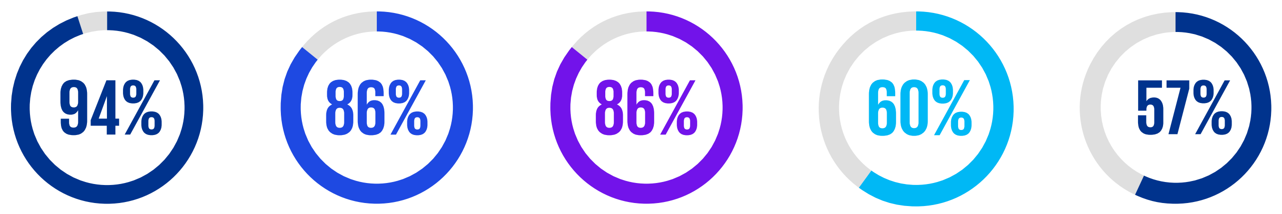
The evolving environmental, social, and governance (ESG) landscape has been stimulated by recent technological disruptions, unprecedented health crisis, mounting social disparities, and global climate crisis. Today, every organisation has embraced an ESG agenda to ensure responsible business practices throughout their value chain. The current approach looks far beyond the traditional ESG criteria and adopts financial metrics to bring sustainability as a critical evaluation parameter for employee remuneration. As forward-looking organisations delve deeper into ESG goal setting, they recognise employees are at the fulcrum of progressing action. In lieu of the same, incentivising employees through integrating ESG into the payroll can potentially accelerate the company's overall ESG agenda. Incentive plans which reflect the synthesis of ESG goals into them, harness the ability to align employee behaviour, actions and efforts towards the attainment of the company's ESG objectives.

Previously, the ESG Council of KPMG in India's Board Leadership Center (BLC) has shared perspectives on incentivising ESG linked performance. It highlighted how ESG metrics are rapidly making their way into corporate boardrooms and becoming a prominent component of incentivising C-Suite. This document furthers the discussion on ESG linked remuneration and delves deep into the ecosystem required for integrating ESG factors into the employee pay structure.

Relevance of ESG linked remuneration



94% of directors across the companies support the usage of non-financial goals.

86% of investors want an ESG metric in their incentive plans.

86% of employees want to work with the companies with same ESG values that employees have.

60% of S&P 500 companies integrated ESG metrics in their incentive plans in 2020.

57% of large companies have already added an ESG metric.

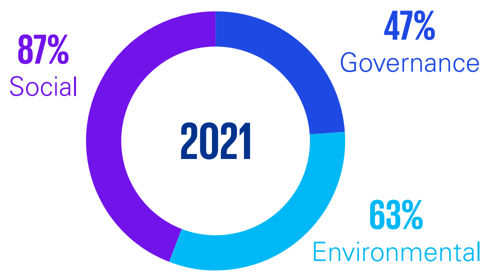
Our experience suggests that it is important for organisations to involve employees for driving the culture through incentivisation and also making them accountable for the determined objectives. There is enough empirical evidence and some companies in 2021,handed over payouts around 100% of target. In 2021, we know several examples where the ESG metric rating at 100% reduced the very strong interim weighted payout from their financial results.
Source: The perils and promise of ESG based compensation- a response to Bebchuk and Tallarita | Harvard Law School Forum on Corporate Governance | 27 April 2022

Socially responsible organisations are moving beyond just making assurances and claims about their ESG commitments to connecting the dots between the organisations' ESG vision and empowering employees as enablers for achieving ESG targets.

Embracing ESG practises that prioritise social and environmental concerns drives employee loyalty that enhances productivity and fosters workplace success.

Decoding the maze of ESG incorporation into pay

Incorporating ESG metrics into incentive plans requires carefully designing and calibrating achievable and palatable goals. In 2021, ESG-linked pay appeared as an emerging trend with companies deploying social and environmental metrics into their employee remuneration plans. As companies enter the unchartered waters of ESG linked employee remuneration, a robust action plan is required. The steps below aim to accelerate the effective integration of ESG through fostering an ESG culture, alignment with the company vision, stakeholder inclusivity and appropriate metric identification.



Source: Inclusion of ESG metrics in incentive plans evolution or revolution | 30 March 2021

Nurturing an ESG-centric culture

The Board and its committees are the custodian of shaping the sustainability culture and hence it is the responsibility of the Board to cascade an ESG mindset across the organisation. In lieu of the same, Board's Nomination and Remuneration Committee (NRC) will have to realign incentives to reflect the shifting focus. The critical role of the Board includes setting the tone at the top, agreeing on a common language, creating a sense of purpose, and communicating their direction, goals, vision, and strategies with regard to ESG issues to key stakeholders through various communications channels. For nurturing a strong culture, ESG mindset must be cascaded throughout the company by building capabilities and awareness.

STEP 2: Aligning with vision, mission and business strategy

Using company's purpose, vision, and strategy, the ESG linked pay structure can be weaved in the existing remuneration processes. The pay structures implemented by the compensation committee must be modified to be inclusive of ESG performance as well as the latest prevailing approaches in the ESG compensation landscape. The NRC will further be responsible for bringing structural changes and defining key responsibilities.

STEP 3: Engaging with stakeholders

Companies must be cognisant of the varying perspective of their stakeholders to gauge whether they are on the right path. They must engage in thoughtful and cautious dialogue with internal and external stakeholders. Internally, the appropriate set of employees must be identified in order to garner their perspective on the identified goals and existing metrics. Their opinions are translated to the Board's NRC which further designs appropriate mechanisms and incentive plans in line with the employees' expectations of the ESG metrics. Companies can narrow down on the most important ESG metrics by conducting periodic ESG materiality assessments and augmenting with stakeholder engagement initiatives.

STEP 4: Identify the appropriate metrics

ESG metrics must be identified and tracked by the NRC to construct reward benchmarks and reinforce the company's ESG strategy and culture. Employee compensation based on ESG metrics has a simple rationale: pay should be correlated with the efficiency that improves a business's ability to create value for its stakeholders. However, for employee compensation plans to succeed, they must have precise targets supported by KPIs that align with the corporate strategy. When a company chooses to incentivise employee pay with non-financial ESG metrics, the metrics should be measurable and transparently communicated. It should be appropriately structured into the pay component either as short-term, long-term incentives or both, depending on the company's goal and the sector it will be implemented in.

Bringing ESG remuneration into action

The key ESG focus areas for an organisation are identified in line with the company's larger vision and stakeholder expectations through a structured materiality process. NRC will play a critical role in reinforcing accountability of the key ESG focus areas by devising specific targets with support from relevant functions. It is important the KRAs must be aligned with the company's ESG objectives and the individual employee roles. This approach will ensure horizontal as well as vertical integration of ESG based pay.

Across its current charter of responsibilities, the NRC can implement relevant metrics through the identified KRAs that align the departments' efforts to achieve ESG objectives. Clearly defined metrics can be further given weightage to formulate the compensation structure of the entire workforce in action. These performance metrics can be linked to the remuneration and rewards platform using the tools mentioned in KPMG in India's previous PoV, "Incentivising ESG linked performance."

The framework below illustrates the steps for assimilating and expanding ESG metrics across functional levels of an organisation and tailoring the ESG journey for every single employee. The relevant role of the functional departments in implementing ESG and the specific metrics set for them are disclosed in in the framework below which are illustrative in nature.

Adjust the existing mission and vision to be inclusive of ESG

Engage with stakeholders for their buy-ins on ESG linked remuneration

Leverage stakeholder engagement to identify key material topics in line with key critical goals and targets

The material issues should be made relevant to specific departments/functions who can take the overall responsibility of its implementation. It is important to identify and task the roles and responsibilities of each functional department that are critical in improving the performance of the material topic.

Once the departments are identified, discussion with the functional heads will help in identifying the relevant KRAs (target) to be set on Y-O-Y basis in order to achieve the ESG objectives. The KRAs can be further enhanced and defined in a strategic manner based on its alignment with the department specific priorities. These quantifiable objectives should be discussed with employees and mapped to their skills and goal sheets in order to achieve maximum participation and transparency.

The NRC further plays a role in conducting awareness sessions and assigning weightages to the KRA's for respective departments across the organisation to drive the pay program effectively.

	Water		**Human rights**	**Customer safety**	**Packaging**		
Functional department	**Research and Development**	**Operations**	**Human Resource**	**Operations and Customer Relations**	**Procurement**	**Engineering**	**Logistics**
Role in ESG	• Design products with an eco-conscious lens • Modify product requirements for lesser water quantity.	• Modify process requirements to practice reduce, reuse and recycle • Drive Zero Liquid Discharge (ZLD) facilities.	• Develop policies which ensure equal remuneration, and address child labour as well as forced labour • Conduct regular training on human rights • Enhance diversity and inclusion through policies and initiatives.	• Maintain product safety and quality standards by ensuring adherence to governmental guidelines and regulations • Effective A/B and pilot testing of products before making them available to the general public.	• Develop sustainable procurement policies • Supplier screening to drive the sustainability agenda across the value chain	• Optimising utilisation of resources during product development • Drive responsible consumption by developing products that reduce post consumption footprint.	• Ensure sustainable logistics to collect, segregate and recycle plastic packaging waste.
Illustrative metrics	• Achieve 5% of the target to become water secure • The company recycles > 20% water (plant owned locations).		• Increase women diversity by 30% • Enhance the number of trainings conducted by 5%.	• Ensure zero incidents regarding cybersecurity breaches.	• Achieve 15% of recycled content within the company's plastic packaging • Reduce the packaging-to-product weight ratio by 2%.		

NRC to determine the appropriate quantum of weightage for each of the determined metrics

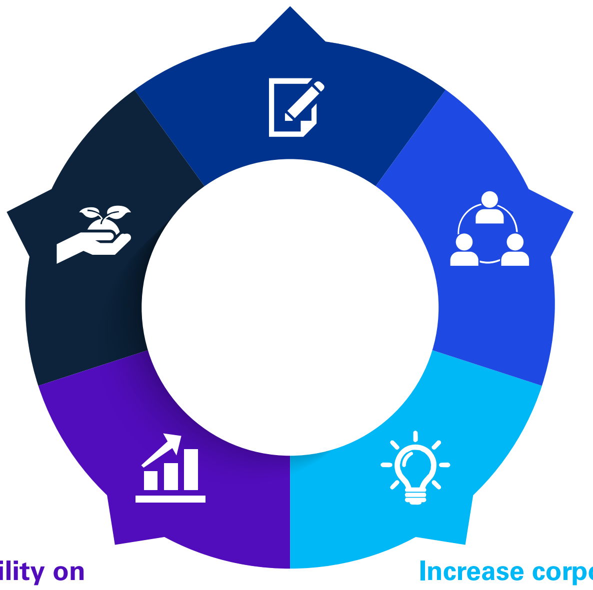
Proceeding with prudence

As organisations navigate through the growing momentum around ESG compensation, they may stumble across certain challenges for seemless implementation of ESG linked pay. Linking ESG measures and employee remuneration can be a robust mechanism and requires puissant measures to promote and implement change. To create an effective incentive design, companies should have trust in their metrics before integrating ESG goals into pay.

On the flip side of the coin, ESG linked pay program presents a myraid of benefits which can be availed for augmenting sustainable value creation. For companies that can endeavour a pre-emptive journey through the high tide of ESG remuneration will sail faster and for the rest, it will be a rough tide.

Incentivise management teams to integrate material ESG goals into corporate agendas

Provides employees with a sense of purpose which correlates with higher job satisfaction and productivity



Help lessen scrutiny from investors, regulators, and other stakeholders

Better accountability on sustainability-related performance across management

Increase corporate value by putting less emphasis on short-term performance targets and more on long-term sustainability objectives

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