SUSTAINALYTICS
Thematic Research

ESG Spotlight

The state of pay: executive remuneration & ESG metrics

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Themes:
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Region:
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Key insights

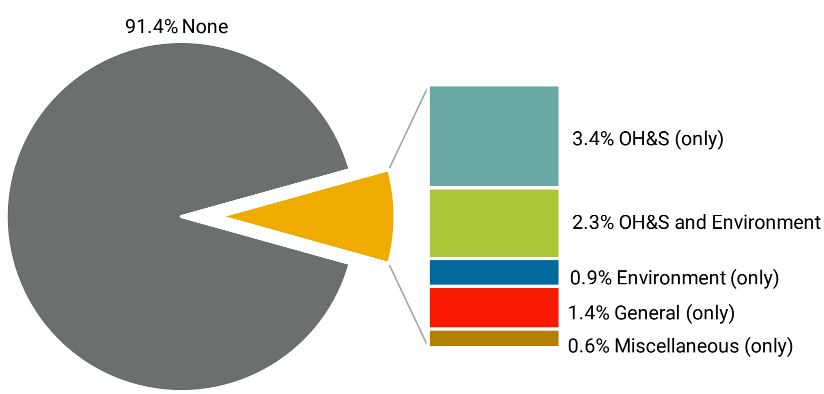
- Only 9% of FTSE All World (AW) companies link executive pay to ESG criteria, most of which address occupational health and safety (OH&S) concerns.
- A sizeable portion of firms based in Australia (20%), Canada (16%) and France (10%) disclose pay-links that we regard as relatively transparent.
- The median Lost Time Injury Rate (LTIR) for at-risk firms with an OH&S pay-link is 0.19 per 200,000 hours worked, versus 0.09 for those without one.

Pay-links in the global equities market

As shareholders and boards are increasingly cognizant of environmental, social and governance (ESG) issues, many are scrutinizing how corporate leadership may be incentivized to pursue an ESG agenda. In recent years, Shell, Chevron, Equinor and several other oil and gas majors have announced new links between executive pay and ESG criteria, including emissions targets.

This report offers insights to global equity investors looking to assess how ESG criteria are factored into executive variable remuneration plans (“ESG pay-links”). While recent headlines have focused on climate-related pay-links, most actually address OH&S, as shown in Exhibit 1. Less than 40% of all ESG pay-links are transparent about how targets are factored into executive pay, with this quotient dropping to negligible levels in key European markets. Gold and Integrated Oil & Gas are subindustries with the largest share of firms implementing OH&S pay-links, reflecting their high exposure to this issue. While some pay-links appear proactive, the median LTIR of at-risk firms that have an OH&S pay-link is twice as large as it is for firms without one. Our analysis aims to help investors considering pay-links as a topic for corporate engagement.

Exhibit 1: Types of ESG-linked compensation incentives, FTSE AW index*



*n=2,684, full sample covers 98% of the FTSE AW by weight; benchmark proxied by VWRD exchange-traded fund (ETF).[2] This analysis includes both long and short term pay-links. **Sources:** Sustainalytics[3]

Transparency, market norms and sector exposure

ESG pay-links in context

ESG performance metrics – also known as ESG pay-links – are criteria that tie executives' variable remuneration to the fulfilment of targets related to sustainability, ethics or other social or environmental considerations.[4] While such incentives are hardly novel, they have recently been brought to the forefront by publicized plans of energy and extractives firms, including Equinor,[5] Chevron,[6] BHP[7] and Shell,[8] to align executive pay with carbon emissions targets.

Breaking with convention

ESG pay-links are much less common than conventional variable remuneration criteria that focus on profitability and return-oriented performance metrics, such as earnings per share and total shareholder return. Although ESG pay-links face many of the same challenges of transparency and verifiability as their traditional financial counterparts, these concerns are often more pronounced for ESG pay-links, which tend to lack clearly operationalized metrics.

The importance of transparency

Transparency is a key consideration when evaluating the degree to which ESG pay-links can be expected to incentivize executives to pursue an ESG agenda. For this study, we denote a pay-link as "highly transparent" when it states specific ESG criteria and how they are factored into the broader compensation package, and includes either ex ante targets or ex post fulfilment data.

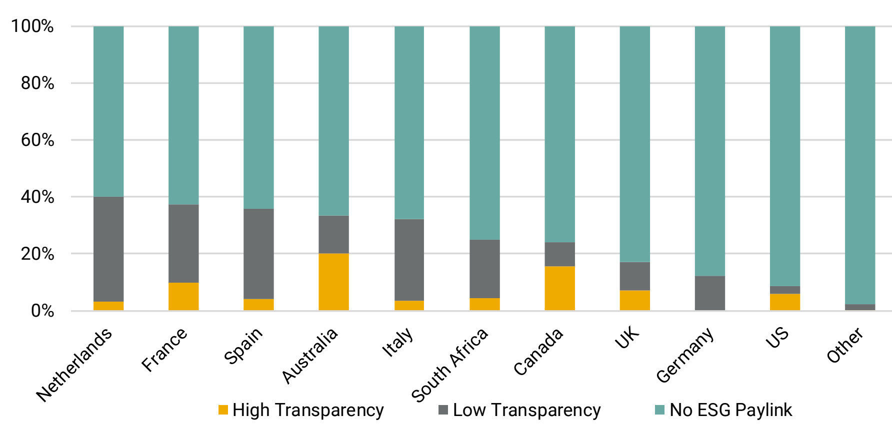
Market analysis

While only 0.03% (89 of 2,684) of our sample meet these transparency criteria,[9] we find substantial variation by market, as shown in Exhibit 2. At the high end, a relatively large portion of firms based in Australia (20%), Canada (16%) and France (10%) disclose pay-links that we regard as "highly transparent," while a negligible portion of those in Italy (4%), the Netherlands (3%) and Germany (0%) fall into this category. These differences are driven by distinct market norms, regulations and the concentration of certain sectors in each country. Australia, for instance, has relatively strong laws that promote transparency and a concentration of firms in Energy, Utilities and Materials sectors, where OH&S risk is a concern and transparent pay-links are more common.[10]

Understanding best practices

This analysis may help investors assess the extent to which a company's executive remuneration plan is in line with best practices in each market.

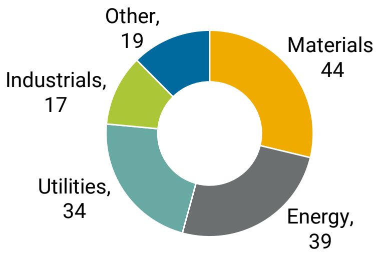
Exhibit 2: Assessing the transparency of ESG pay-links by market, FTSE AW*



*n=2,684 firms; FTSE AW index proxied by VWRD ETF. **Source:** Sustainalytics

Blue collar occupational health and safety risks

Exhibit 3: Number of FTSE AW firms with OH&S pay-links by sector*



*n=153 firms; FTSE AW index proxied by VWRD ETF. **Source:** Sustainalytics

ESG pay-links are sometimes seen as counterweights to the pure profit motive that traditional performance metrics could otherwise engender. However, our analysis suggests that they are often used in service of profit motives, rather than in spite of them. The bulk of ESG pay-links (153 of 232, or 66%) address OH&S risks, such as worker injuries (falls, slips, burns, etc.) and fatalities, which can have negative financial impacts associated with facility closures, delays, investigations, legal actions, fines and reputational damage.[11] As shown in Exhibit 3, three blue collar sectors – Materials, Energy and Utilities – account for 117 of the 153 (77%) OH&S pay-links in our sample.

Unlike the ongoing trend of high-profile pay-links focused on mitigating carbon emissions, OH&S criteria have tended to figure more prominently in executive compensation packages, both in general and in these sectors in particular. As shown in Exhibit 4, between 18% and 32% of the companies in the Energy, Utilities and Materials sectors disclose an OH&S pay-link, while 2% to 8% link executive pay to ESG criteria without an OH&S component.

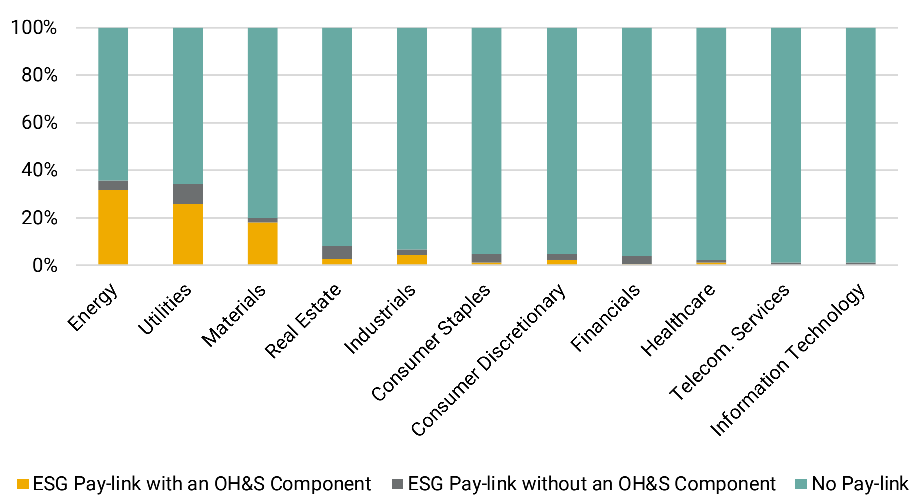
Emissions pay-links on the horizon

However, as investor concern about climate change continues to mount and these sectors face increasing exposure to transition risks, we expect that more firms in this space will implement long-term carbon related pay-links.

Subindustry analysis

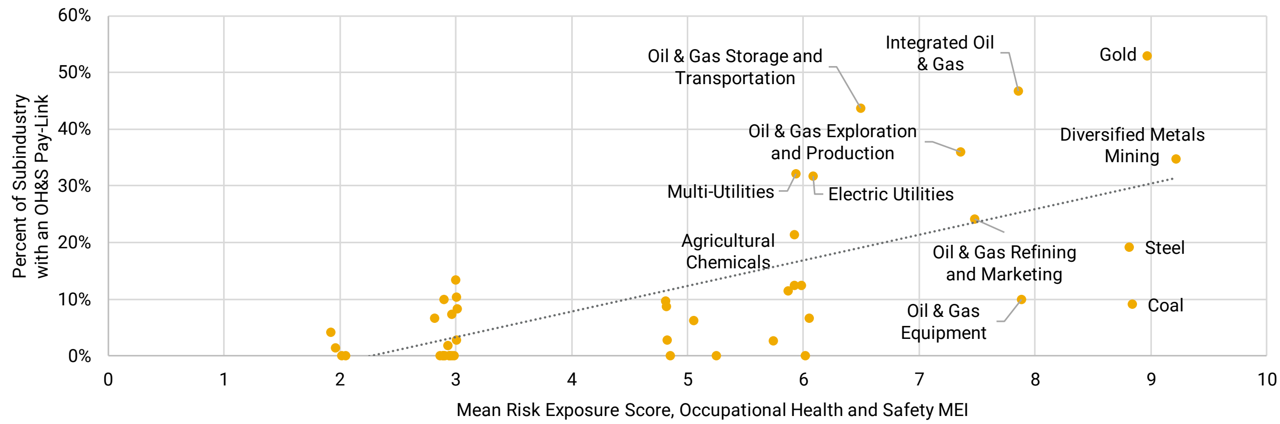
Segmenting our sample by subindustry offers another vantage point. Exhibit 5 (p. 4) shows the percentage of firms that have an OH&S pay-link within 44 subindustries, and each subindustry's mean exposure score on the Material ESG Issue (MEI),[12] Occupational Health and Safety.[13] These two variables exhibit a strong positive correlation (coefficient=0.7), indicating that OH&S pay-links tend to be more common in subindustries where exposure to this MEI is high, such as Gold and Integrated Oil & Gas. Recent news of Shell's CEO having his bonus cut in half, due in part to the seven fatalities that the firm reported last year, illustrates the prevalence of pay-links among extractive players.[14]

Exhibit 4: Percentage of firms with an ESG pay-links by sector, FTSE AW*



*n=2,684 firms; FTSE AW index proxied by VWRD ETF. **Sources:** Sustainalytics

Exhibit 5: Subindustry analysis – safety pay-links and occupational health and safety risk exposure



*Correlation coefficient=0.7; n=44 subindustries each of which includes at least 10 sampled firms; risk exposure categories range from low (score >0 to 3.9) to medium (score 4 to 8) and high (score ≥8); grey line indicate the trend; select subindustries labelled. **Source:** Sustainalytics

Explicit priorities

We anticipate that "pay-for-safety" alignment will be increasingly top of mind among investors analyzing companies that are highly exposed to this MEI. However, we also recognize that for some executives, incentives to mitigate OH&S and other ESG risks may be undisclosed or implicit in traditional financial targets measuring operational efficiency and profitability. Moreover, legal and potential criminal liability may in some cases be enough to motivate executives to promote an OH&S agenda.[15]

Portfolio exposure and engagement

Investors can address portfolio exposure to this MEI by assessing the extent to which leadership teams are incentivized to achieve explicit OH&S targets and engaging with firms to discuss how their approach compares with the best practices of peers in their respective markets and subindustries.

Measuring performance

Laws, standards and inconsistencies

Inconsistencies in how companies report information, including OH&S performance metrics, pose challenges when gauging the extent to which pay-links may contribute to effective risk management. Government agencies, such as the US Occupational Safety and Health Administration,[16] require reporting on injuries that meet specific criteria. Industry groups, such as the International Council of Metals and Mining[17] and the International Association of Oil & Gas Producers, offer guidance on how to report incidents. Still, we see substantial variation in how firms count and report workplace injuries.

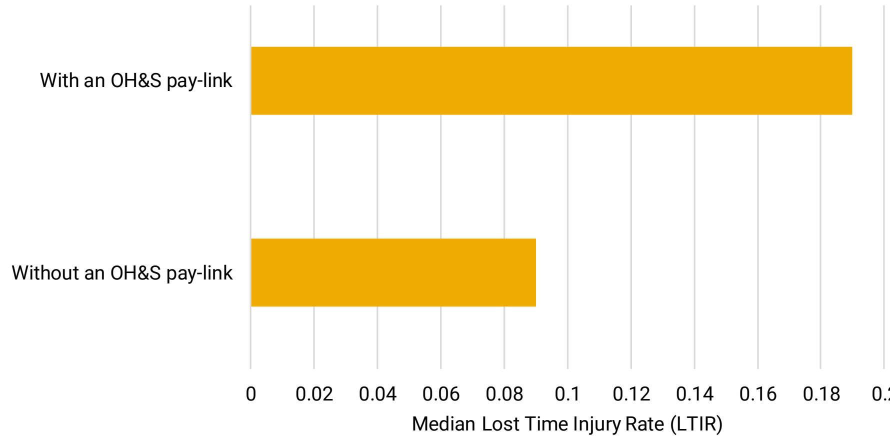
Counts, rates and conventions

For example, while some companies report minor workplace injuries irrespective of whether they involved lost time, others only report incidents that required medical attention or resulted in a worker taking time off. Moreover, conventions for calculating injury and fatality rates vary by market and industry.

Tailoring datasets

To address such inconsistencies, we apply a custom methodology for compiling and normalizing ESG metrics. Leveraging this standardized dataset, we compare the latest reported annual LTIR of 48 Materials and Energy companies that are highly exposed to OH&S risk (MEI exposure score ≥8).

Exhibit 6: Median LTIR of firms with and without an OH&S pay-link*



*LTIR: number employee/contractor injury/fatality incidents resulting in lost time per latest year reported; n=48 firms (22 with an OH&S pay-link, 26 without) highly exposed (score ≥8) to the OH&S MEI. **Source:** Sustainalytics

Applying standardized metrics

As shown in Exhibit 6, the median LTIR of companies that have an OH&S pay-link is more than double that of firms without one: 0.19, compared to 0.09, injury incidents that led to lost time per 200,000 hours worked. This gap can represent a difference of hundreds of workplace injury incidents for impacted companies.[18] While some pay-links appear to be proactive measures to improve ESG performance, this finding suggests that they may also be a bellwether of a company's responsiveness to heightened risk and elevated incident rates.

Alternative strategies

This analysis also underscores the importance of considering other factors, apart from OH&S pay-links, when evaluating how well a company is governing OH&S risks. Additional points that investors can take into account include historical LTIR trends, the potential applicability of internationally recognized OH&S certifications, such as ISO 45001, relevant worker training programmes and the overall quality of OH&S management systems.[19]

Conclusion – a fresh look at corporate governance

A critical eye

This report casts a critical eye on the practice of linking executive pay to ESG criteria. From an overall global equities perspective, pay-links – especially transparent ones – are rare. However, this practice is relatively common within the Materials, Energy and Utilities sectors. Gold and Integrated Oil & Gas stand out as subindustries where OH&S risk exposure is especially high and pay-links are most common. Investors looking to address portfolio exposure to this MEI may consider prioritizing these areas of the economy.

A proactive or responsive measure

While some pay-links appear to be proactive, the median LTIR of at-risk firms with an OH&S pay-link is double that of companies without one, suggesting that such incentives may also be a responsive measure to elevated OH&S incidents. This finding also highlights the importance of other risk management systems.

Holistic risk management

Other factors for investors and management teams to consider when engaging on this topic include a company's exposure to certain MEIs, its track record with regard to related incidents, best practices for transparent reporting in its market and subindustry, and the alternate ESG strategies at its disposal.

Endnotes

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2 Financial Times Stock Exchange (FTSE) All World index proxied by Vanguard exchange-traded fund (ETF), FTSE All-World UCITS (VWRD).

3 This analysis is based on new research that expands Sustainalytics' corporate governance coverage, specifically the Corporate Governance (CG) indicators: CG.4.5 STI Performance Metrics and CG.4.6 LTI Performance Metrics.

4 Karananou, A. and Mooney, O. (2016), Integrating ESG Issues Into Executive Pay: A Review of Global Utility and Extractive Companies, UN PRI, last accessed (14.04.2020) at: https://www.unpri.org/download?ac=1798.

5 Equinor (24.02.2019), "Equinor strengthens its commitment to climate leadership," Press Release, last accessed (14.04.2020) at: https://www.equinor.com/en/news/2019-04-24-climate-action-100plus.html.

6 Chevron (29.05.2019), Proxy Statement, last accessed (14.04.2020) at: https://www.chevron.com/-/media/shared-media/documents/chevron-proxy-statement-2019.pdf.

7 BHP (23.07.2019), "BHP to invest US$400m to address climate change" Press Release, last accessed (14.04.2020) at: https://www.bhp.com/media-and-insights/news-releases/2019/07/bhp-to-invest-us400m-to-address-climate-change/

8 Shell (03.12.2018), "Leading investors back Shell's climate targets," Press Release, last accessed (14.04.2020) at: https://www.shell.com/media/news-and-media-releases/2018/leading-investors-back-shells-climate-targets.html.

9 This analysis includes both long-term and short-term pay-links.

10 The mean OH&S MEI exposure score of companies in these sectors are as follows: Materials 6.4, Utilities 5.7, Energy 7.5. The other eight sectors have mean exposure scores ranging from 2.1 to 5.6.

11 Fairhead, F. and Vezér, M. (2019), "Gold Mines: Unsafe Havens," in 10 for 2019: ESG Risks Loom Large, last accessed (14.04.2020) at: https://www.sustainalytics.com/esg-research/thematic-reports/10-for-2019-systemic-risks-loom-large/.

12 MEIs are a key building block of Sustainalytics' ESG risk ratings. Each MEI focuses on a topic or set of related topics, typically requiring a common set of management initiatives or a similar type of oversight. The OH&S MEI focuses on the management of workplace hazards affecting a company's own employees and on-site contractors.

13 The criteria for including a subindustry in this analysis are (1) the subindustry is exposed to this MEI (i.e. MEI exposure score >0) and (2) the subindustry contains at least 10 companies from our total sample.

14 Bousso, R., "Shell CEO's 2019 pay halves after fatalities, revenue fall," last accessed (14.04.2020) at: https://www.reuters.com/article/us-shell-salary/shell-ceos-2019-pay-halves-after-fatalities-revenue-fall-idUSKBN20Z1BJ.

15 Government of Canada (2019), "Criminal liability for workplace deaths and injuries – Background on the Westray Law," Department of Justice, last accessed (14.04.2020) at: https://www.justice.gc.ca/eng/rp-pr/other-autre/westray/p1.html.

16 OSHA (2019), Recording and Reporting Occupational Injuries and Illness, Occupational Safety and Health Administration, last accessed (14.04.2020) at: https://www.osha.gov/pls/oshaweb/owadisp.show_document?p_id=9638&p_table=STANDARDS.

[17] ICMM, Health and safety performance indicators, International Council on Mining & Metals, last accessed (14.04.2020) at: https://www.icmm.com/en-gb/publications/health-and-safety/health-and-safety-performance-indicators.

[18] For context, the LTIR spread in this sample ranges from 0 (e.g. Inner Mongolia Yitai Coal) to 2.08 (KGHM Polska Miedz). The mean LTIR for companies with an OH&S pay-link is 0.29, compared to 0.25 for those without one.

[19] Sustainalytics' research covers several relevant indicators, including: S.1.6.2.1 Health and Safety Management System, S.1.6.4 Health & Safety Certifications, S.1.6.5 LTIR Trend, S.1.6.6 Employee Fatality Rate, S.2.1.2 Signatory to Responsible Business Alliance (RBA) and Contractor Safety Programme, S.2.2.6 Contractor Fatalities.

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