CANDRIAM
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The State of Pay: ESG Metrics in Executive Remuneration

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Marketing communication

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Remuneration committees are starting to introduce ESG metrics in addition to financial ones in executive remuneration.

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Executive ESG-pay links on the rise.

Publicly-traded companies have begun to incorporate ESG performance metrics into their executives' compensation packages as part of efforts to increase transparency on their accountability vis-à-vis shareholders. Almost three out of four S&P 500 companies (73 %) tie executive compensation to ESG performance in 2021 – an increase from 66 % in 2020[1].

Among indicators used, the most significant progress is found in companies' adoption of diversity, equity & inclusion (DEI) goals, rising from 35 per cent in 2020 to 51 per cent in 2021, illustrating investors and other stakeholders' focus on diversity issues. Furthermore, as a result of ever-growing attention to climate change, the share of S&P 500 companies that tie carbon footprint and emission reduction goals to executive pay also grew considerably, from 10 per cent in 2020 to 19 per cent in 2021.

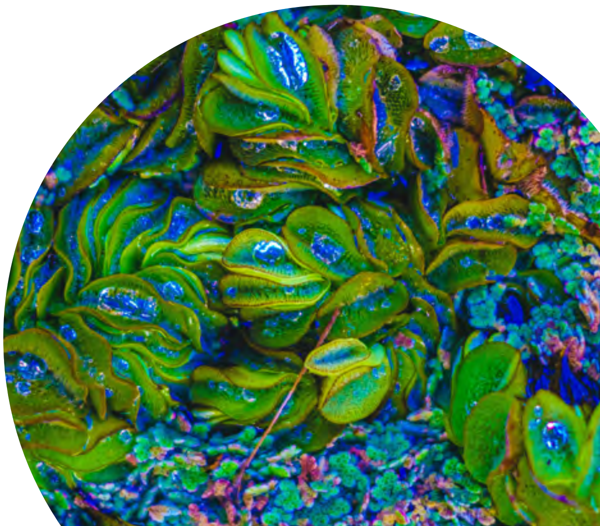
We can observe from these results that remuneration committees are starting to introduce ESG metrics in addition to financial ones in executive remuneration. Where boards' remunerations are demonstrably aligned with corporate strategy and future business performance, the inclusion of ESG performance metrics sends an important signal to executives, employees, investors and other stakeholders.

Why ESG metrics? Double materiality

Introducing Double materiality

For organizations to remain competitive, embedding ESG in their business strategy is imperative. To this end, a key first step is to run a double materiality[2] assessment, as part of an analysis of the organization's inside and outside contexts and the impacts of the company on both of these. Not only is this assessment foundational for integrating ESG in organizational strategies, but it will be required as part of the EU-approved Corporate Sustainability Reporting Directive (CSRD), which highlights the double materiality concept.

The first step in the materiality assessment is to draft a sustainability vision – i.e. an articulation of the long-term impact that the organization wants to manifest in the world[3] - and a list of ESG topics that are most material to the organization. Once this list is finalized and tailored to the company's specific situation, the next steps are to prioritize these ESG topics based on the stakeholders' expectations and to define the targets. To ensure commitment at the executive level, one of the tools is to link the success of these ESG goals to the executives' remuneration.



A three-step approach

- Define the sustainability vision and material ESG topics

Setting a clear sustainability vision is key to anchoring the company's strategy and defining its long-term direction. The vision should reflect the purpose of the company – why it exists -, the long-term picture of the organization – what it is aiming for -, and the values that will support the organization through these changes. Ultimately, a list of ESG topics that are most material to the company is finalized.

- Set short- and long-term ESG goals

To monitor and drive progress, long-term goals and intermediate objectives are crucial. These objectives should be set with support from executives and board members. Progress should be monitored and supported at operational and strategic levels with a clear ownership of responsibilities and reporting lines for each ESG topic and commitment.

- Link ESG goals to executive remuneration

Integrating ESG metrics in executives' variable remuneration, both short- and long-term, is a way to ensure that the ESG strategy is respected.

Trends in different regions: Europe's ESG metrics outpace the US

European companies – including those listed in the UK – have taken the lead globally when it comes to incorporating ESG metrics into executive compensation. 42 of the top 100 listed European companies include ESG metrics as a variable component of executive pay, and across the universe of all listed European companies, approximately 17% of them have implemented an ESG-pay link, versus 13% in the United States and Canada[4].

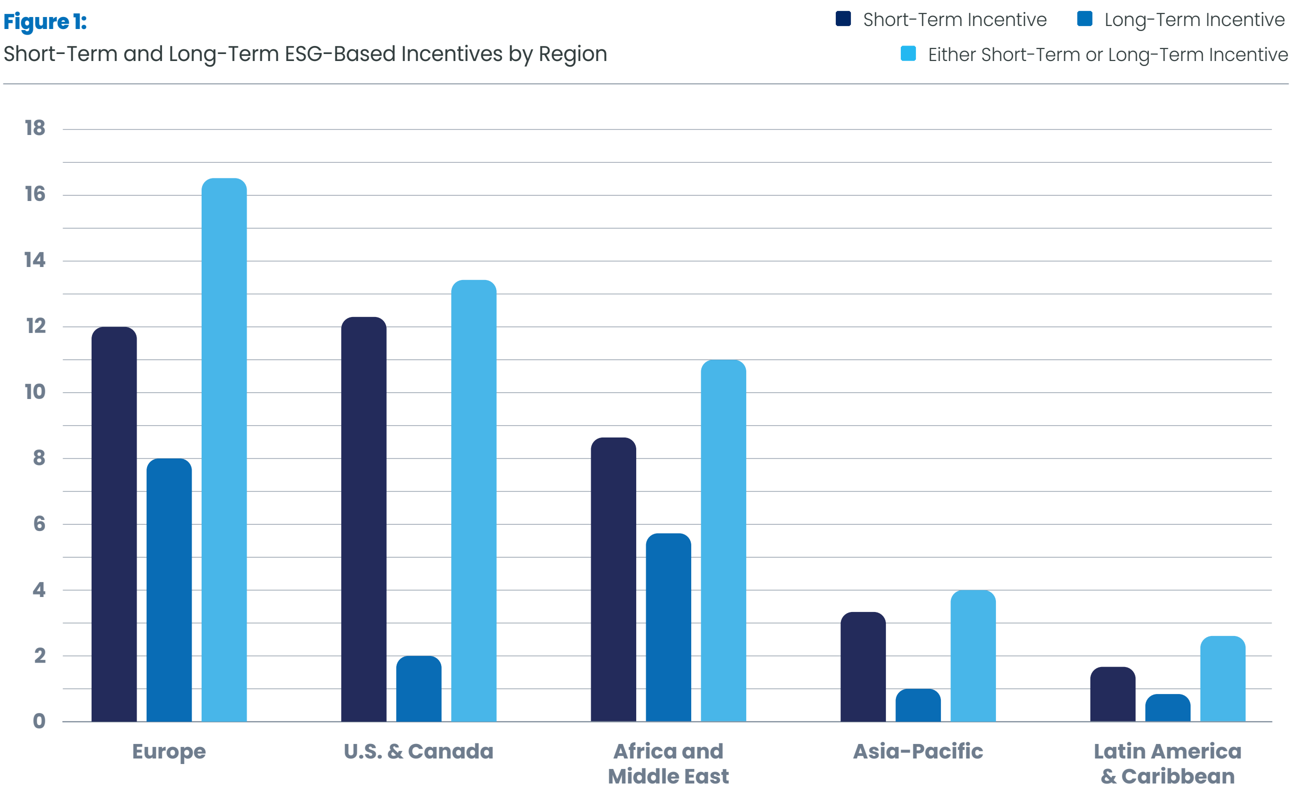
Although Europe is a leader in the inclusion of ESG goals in executive pay, there are considerable differences across the various countries. It is not common practice yet in Sweden, Norway, Denmark, and the Baltics. Countries where ESG performance measures are relatively common include France, where roughly 70 per cent of the largest 50 companies use them as of 2021, the UK, where 54 per cent of companies include some kind of ESG metric, and Switzerland, where one-third of the top 100 companies and two-thirds of the large-cap index companies link executive pay to ESG.

In Europe, the trend to link ESG performance to executive pay is predominantly driven by regulations and an evolution in corporate governance codes. For example, "say-on-pay" regulations in several European countries are adding further provisions to encourage the link between sustainability and pay; the Shareholder Rights Directive II brings increased transparency about non-financial metrics in compensation plans; the French corporate governance code recommends the integration of ESG metrics in executive compensation plans; and the Financial Conduct Authority recently outlined three new diversity targets for UK-listed companies, including a goal for boards to be at least 40 per cent gender diverse (source: Harvard).

In the US, the trend is largely market driven. It's unlikely that any of the SEC's upcoming disclosure rules will require the inclusion of ESG factors in compensation programs. Indeed, the SEC's recently adopted Final Rule on Pay Versus Performance does not require disclosure of non-financial measures.

Asia-Pacific is a laggard with less than 4% of companies having an ESG incentive plan in place. However, almost 70% of firms in the region plan to introduce ESG measures into their long-term incentive plans over the next three years, while 61% plan to do so with their short-term plans.[5]

Figure 1:
Short-Term and Long-Term ESG-Based Incentives by Region



Source : Sustainalytics data (% of companies with incentives)

Elements to consider.

While the business world is reacting to the increasing pressure on demonstrating not only their financial performance but also the business performance as a whole, expectations continue to be scaled up. ESG matters have gained legitimacy and airtime in investors' discussions with companies, and so the question has shifted from *whether to add incentives to* achieve their long-, medium- and short-term ESG targets, to *finding the right ones*.

Let's focus on the essential elements that companies need to take into account. Then, we will explain Candriam's approach for analyzing executive remuneration packages of investee companies.

Including ESG metrics into executive remuneration has been the most trending and demanded way to push for increasing companies' ESG performance as well as to hold executives accountable for ESG results. However, choosing ESG metrics that are relevant, challenging and reflective of the business is not an easy task. Issues arise when this process is considered as a box-ticking exercise rather than an opportunity to truly identify which ESG metric would be the most relevant and would create most sustainable long-term value for the business. Companies that wish to create an impact through their business prefer to avoid any form of greenwashing, including adding metrics in their executive compensation packages that are not relevant for, or lag, their ESG targets. Identifying and implementing the right metric is a key element in companies' demonstration to stakeholders that they are walking the talk.

As an increasing number of companies now integrate ESG metrics in their executive remuneration, it has become essential to differentiate the companies that truly drive long-term sustainable value from those that are missing the point. Prompted by investors' demand for more disclosure and higher transparency and pertinence, regulators have introduced more detailed guidelines. At the global level, the World Economic Forum[6] published a white paper that provides common metrics and guidelines for a consistent reporting of sustainable value creation. Furthermore, the European Union, the UK Prudential Regulatory Authority and the US Securities and Exchange Commission, noting the increased importance given by investors to reporting ESG risks, have also published some guidelines. Although there is still no straight and plain handbook for investors to analyze which metric a company should link its executive remuneration to, several indicators should be considered when assessing their stringency.

Short- and long-term incentives

However vibrant is investor demand for companies to select relevant metrics and communicate clearly and objectively their assessment to the public, the type of plan in which the ESG metrics should be integrated is still a question. While there is no set rule or preference on the investor side, current market practice shows that social metrics, that can easily be tracked annually, are more often included in short-term incentive plans, whereas environmental KPIs have more of a long-term nature and may imply organizational changes in order to accomplish companies' sustainable vision. According to a study published in 2021[7], less than five per cent of companies in the S&P 500 adopted ESG metrics in their performance shares plans, which by nature are long-term; this is significantly lower than the share of companies that include ESG metrics in their annual plans (57 per cent). One reason for this could be that the integration of such metrics in variable plans upon investor feedback could be achieved faster through using annual plans, in case the company did not have a yearly running long-term incentive plan (LTIP).

All in all, in order to achieve the ultimate target of an ESG KPI over a longer period, it is indeed best practice to set intermediary (yearly) business targets, and these should be reflective of the business strategies and priorities as explained above. Actually, all long-term targets should have yearly achievement thresholds translated into the annual variable remuneration plans. It is always preferable to have ambitious and well-designed targets based on yearly expectations, rather than vaguely expressed long-term targets. While some environmental goals have a long-term orientation, a clear projection with yearly targets is needed to achieve the desired result within a specific period. As such, the type of plan where ESG metrics are included in the scope does not bear significant importance as long as the metrics and targets are challenging for the business and aligned with the strategy. This being said, **we hold the position that companies' short-, medium- and long-term incentives should be linked to the overall business performance in any case; therefore, we encourage the inclusion of relevant ESG metrics in all plans.**

ESG metrics weighting

The question of 'what is the most appropriate weighting of ESG metrics in a variable pay plan?' has been a source of debate since companies started including ESG metrics in executive remuneration. We have seen in JP Morgan's 2021 paper[8] that ESG KPIs account for 15 per cent of annual bonuses and 16 per cent of long-term incentive plans for FTSE 100 companies.

However, this is not a set-in-stone rule as some companies in our portfolio have tended to increase weightings for ESG metrics, in line with the weighted importance they give to ESG performance in their business strategies. For example, Unilever* gives a 25 per cent weighting to the Sustainability Progress Index metric for its long-term incentive plan. This index includes a reduction of greenhouse gas (GHG), the reduction of waste, positive nutrition and the protection and regeneration of nature. On a similar note, Danone* applies a 20 per cent weighting for the non-financial metrics attached to its short-term incentive plan, with 10 per cent linked to employee engagement.

When analyzing ESG metrics, we pay close attention to the nature of the chosen metrics, to their alignment with the business strategy, and to the weighting they should have in the variable pay plans.

Disclosure and Targets

Disclosure of companies' activities, business risks and outcomes has been one of the most recurring demands from investors willing to assess if shareholder value is not being exploited by the agents. The same principle applies to the integration of ESG metrics into executive remuneration packages: the pay-for-performance principle is a way to align the interests of executives with those of other stakeholders. Only with enhanced transparency on how the pay is granted based on the companies' ESG performance can we understand whether such alignment is measured accurately.

* This is a portfolio security.

Choosing how metrics can be integrated into a plan depends on various elements such as the type of variable pay plan and the business purpose. We come across the following industry practices that are followed by companies that have introduced ESG measures in their incentive plans:

- **Scorecard:** in this practice, metrics do not have individual weightings but they are attach ed to a non-financial metric list, and assessed mostly in aggregate (e.g. 25 per cent of the short-term incentive awards are tied to non-financial metrics).
- **Stand-alone:** The metric is linked to a stand-alone weighting in the plan, and includes predefined levels at the threshold, target and maximum performance. This is suitable for attaching individual goals to each executive with different weightings.
- **Performance Modifier:** This practice is used to modify the entire payout downward or upward.
- **Underpin:** ESG metrics are underpinning the need to be achieved before the assessment of the incentive plan. In other words, the ESG target should be achieved before the full incentive assessment starts.

According to Deloitte's review of Fortune 100 companies' proxy statements, **the most broadly used way of integrating ESG metrics in executive annual plans is the score-card approach, followed by a modifier and stand-alone measure.** It is important to highlight that this is an individual choice at the company level. There is no preferred way of including an ESG metric as long as the company's performance assessment is reflective of the company's overall business performance, and that the chosen target levels are both challenging and accurately communicated to stakeholders. Actually, most ESG metrics are included in a score-card-based approach which is easier to implement than an individual assessment, including for the metrics that are difficult to quantify. However, this may leave more room for the discretion of remuneration committees, and this discretion should be communicated clearly to the public in annual reports and come with a compelling rationale.

Remuneration committees also bear the responsibility of selecting appropriate and relevant ESG metrics and assessing performance against the list of sets of targets determined at the beginning of a performance period. Not only should these metrics be communicated, but also the set targets, which should be transparent and challenging to ensure incentivizing outperformance. By challenging targets, we refer to:

- The target levels that have not yet been reached by the company during the last performance periods;
- The target levels that are objectively measurable (to avoid any greenwashing practices); for non-measurable targets, the assessment process by the remuneration committees should be disclosed in detail;
- The target levels that not only bring absolute out-performance but also reflect performance against peers.

In this case, it is noteworthy that **for the choice of metrics there is no one-size-fits-all approach**, as long as they are aligned with the business strategy and well-justified by companies. Some companies have integrated external KPIs such as Dow Jones Sustainability Index World and Euronext Vigeo World & Europe9, while other companies adopt internal KPIs that allow internal benchmarking. "External KPIs" refer to external targets based on stakeholder impact measurements such as carbon emission targets, employee engagement scores or water use. Whether external or internal, no KPI is more reliable or valid than another, however, KPIs should be aligned with the company's strategy and priorities. The data used for assessment should also be collected and analyzed appropriately. One drawback of internal KPIs could be their potential lack of objectivity. To avoid this pitfall, we expect companies to select objectively measured quantifiable targets and possibly have the internal KPI performance audited by an independent third party.

Lastly, there should be a link between the ESG metrics and the scope of responsibility of their potential beneficiaries. A broad-based metric such as customer satisfaction may be a key KPI for all employees, while increased diversity or recycling rate would be a more relevant indicator for the executives in key management roles, due to their position as strategic decision-makers.

Alignment

With the implementation of the new reporting standards of CSRD, companies have upgraded their reporting practices on the ESG issues relevant to their business. So far, executives' incentives were linked to financial and operational goals; now that companies integrate ESG issues into their corporate strategies, these issues should make their appearance in executive remuneration plans.

Companies that are adopting the integration of non-financial metrics in their executive remuneration should explain the link between their chosen specific metrics and the ESG risks and targets that are relevant to their business activities. The choice is clear when companies have already decided upon certain ESG metrics in their business plan. In any case, the rationale should always be communicated clearly to the stakeholders with a compelling reason. The motivation for selecting a specific metric may vary depending on the company's stage in its ESG journey: either to better reflect the company culture, or to change it, or to manage ESG risks. The metrics attached to executive plans should reflect the companies' main priorities as this sends a clear message to stakeholders about the board's commitment and targets for the upcoming term. For companies that lack an ESG agenda and struggle with identifying key ESG issues, engaging with stakeholders on ESG is an important starting point. For those that have already begun their integration journey, periodic ESG materiality assessments allow them to keep their ESG agenda up-to-date and follow fast-evolving investor expectations.

We entertain the possibility that it may take time before this integration of ESG metrics into executive remuneration becomes the prime mover in companies' sustainability journey; however, companies who have aligned their remuneration structure with their business strategies including ESG goals will be recognized for providing more accountability, and earn trust from stakeholders.

A way to ensure this alignment of ESG metrics could be for companies to make use of ESG operating goals for a certain length of time before integrating them firmly into their compensation plans. This testing period could be an opportunity to assess whether those goals are relevant for the business, challenging enough to develop strong management, and whether they would help companies address difficulties they face when measuring and reporting on non-financial performance.

Overall, companies are expected to include goals that are material and auditable and sufficiently challenging to put compensation at risk in case of management's failure to reach them. The inclusion of ESG metrics should not be used to increase the quantum of the payment to executives, or to simply tick the box. Companies should consider what their end goal is for including non-financial metrics: this could be to improve their non-financial performance, show stakeholders that a specific metric is material for the business, or have a societal and/or environmental impact - or all of the above.

According to data discussed in the *ESG Performance Metrics in Incentive Plans Roundtable* in 2022[1], the driving decisions for more than 50 per cent of the participants to integrate ESG goals in executive pay include signaling that ESG is a priority, responding to investors and board expectations, and achieving companies' ESG commitment. Before linking executive pay to ESG goals, companies should focus on non-financial KPIs through their strategic perspective. Searching for areas where companies can make the biggest impact on the stakeholders' value could be the starting point to choose what would be the most appropriate metric.

Performance assessment

After selecting clear metrics with challenging targets, companies should communicate transparently on related ESG performance assessment. They may follow the leading global standards and reporting frameworks as a reference to define the KPIs used to measure performance and determine the potential achievement of each target. Global standards provide greater comparability across peers.

As many ESG goals are qualitative, their assessment is based on subjective appreciation. What investors require from companies, in this case, is an objective assessment of the performance measurement method and whether this assessment is fair and reasonable. A third-party audit would bring insights into how companies measure performance, and whether the reported achievement is objectively assessed based on the calculation method used for a specific metric. Disclosure around the achievement of each performance target should include qualitative and quantitative analysis by the companies' legal, finance, investor relations or communication teams; additionally, the board's assessment and oversight for such analysis should be attached to the end-year report. Responsibilities for data collection and performance assessment should be made clear, as well as the board's potential interference. These are the main areas in which companies are falling short of investor expectations – they tend to show reluctance to report on quantitative inputs from internal organs and use general and vague language to explain their assessment of targets.

Finally, if the board decides to use downward or upward discretion for the actual payout for each metric, the rationale behind this decision should be stated in the companies' reports.

Conclusion of our general view

Overall, Candriam's approach to analyzing the materiality and relevance of an ESG metric attached to a variable pay plan is based on eight main questions:

Elements to consider	Questions to Ask
Short- and long-term incentives	1. Is the chosen time horizon in line with the business strategy?
Weightings	2. Is the weighting given to each metric challenging and relevant for the company?
Disclosure & Targets	3. Does the company provide clear disclosure on the rationale for selecting ESG metrics?
	4. Is the disclosure of the reasons behind the choice of metrics and targets clear and understandable?
	5. Is the metric clear, measurable, challenging, forward-looking and attainable?
Alignment	6. Is the ESG metric relevant to the company's ESG strategy?
Performance assessment	7. Does the company provide sufficient disclosure on the assessment of each performance metric and its achievement?
	8. Does the company explain the discretion used if any?

While we analyze each company on a case-by-case basis, our main voting drivers are the answers we find in the companies' communications, meeting materials and annual reports. To assess whether a specific ESG metric is aligned with the company's strategy and forward-looking ESG goals, we collaborate with sector analysts. As such, our vote on the materiality and relevance of an ESG metric is a common work of sector analysts and voting specialists.

Study based on data provided by Vlerick Business School.

For the purpose of this study, we partnered with Vlerick Business School's Executive Remuneration Research Centre to analyze the datasets collected through the extensive work of a dedicated team supervised by Prof. Dr Xavier Baeten and Marthe Van Hove. Their remuneration database is based on information collected from companies that are part of STOXX Europe 600 index. The geographical scope is limited to 16 countries.

Figure 2:
Countries targeted by the study

Source: Candriam, Vlerick Business School

The dataset provided by Vlerick Business School includes the use of specific metrics in subject companies' short- and long-term incentive plans.

One of the first conclusions drawn from data collected between 2014 and 2021 is that the median CEO remuneration level at sample companies has increased by 29 per cent while the increase in the hourly cost of employees in the Eurozone rose by 12 per cent. In contrast, the median of the STOXX Europe 600 index companies' market cap has increased by 66 per cent.

To acknowledge the exceptional market context in 2020 and 2021 due to the Covid-19 pandemic, the Vlerick Business School also studied the median of CEO remuneration between 2014 and 2019. When excluding years 2020 and 2021 from the analysis, the median of CEO remuneration increased by 11 per cent versus 8 per cent for the hourly cost of employees, while the increase in the market cap was 33 per cent. A closer analysis of the various components of the remuneration package shows that the base pay levels remained rather stable while there was a significant drop in short-term incentive levels in 2020 (11.4 per cent). This was followed by an increase in 2021 (43. 1 per cent) due to modifications of the annual bonus plans' performance assessment and target levels after assessing the impact of COVID-19 on companies' performance in 2020.

Another observation was that there is indeed a correlation between companies' financial return and the short-term incentive component payouts of the total CEO remuneration levels. This confirms that financially successful companies grant higher short-term incentive pay to their executives. However, data also confirmed that non-financial performance also has an impact on the company's overall performance, hence on annual bonus payouts. A positive link was found between the sample companies' sustainability rating and the short-term incentive payouts, which confirms that companies with a higher sustainability score are more prone to achieving the targets in their short-term incentive plans.

When we dive into the structure of variable remuneration to analyze the level of ESG metrics inclusions in CEO remuneration, the picture is not promising. According to the findings, only 3.8 per cent of CEO remuneration at sample companies is driven by one of the largest societal ESG challenges. Focusing specifically on environmental KPIs, only 8.8 per cent of total CEO remuneration is linked to environmental KPIs at firms that use such metrics in their CEO remuneration packages. The conclusion is that the inclusion of ESG metrics, and more specifically environmental ones, has not yet reached maturity, and its impact on remuneration levels is limited in the face of the compelling and urgent challenges we need to tackle.

The conclusion is that the inclusion of ESG metrics, and more specifically environmental ones, has not yet reached maturity, and its impact on remuneration levels is limited in the face of the compelling and urgent challenges we need to tackle.

Analysis of ESG metrics used in executive remuneration packages of STOXX Europe 600 companies

Looking at remuneration packages in 2021, the weightings of non-financial KPIs in short- and long-term incentives are 27 per cent and 10 per cent, respectively. This confirms that companies tend to link their annual variable pays to their non-financial performance indicators rather than include them in their long-term plans. This opens up different discussions we have touched upon in the previous section “Elements to consider”, as there might be different reasons and challenges for companies to use a long-term target for a performance indicator with a potential lack of foreseeability. Instead, it is easier to predict the possibility of achieving yearly milestones.

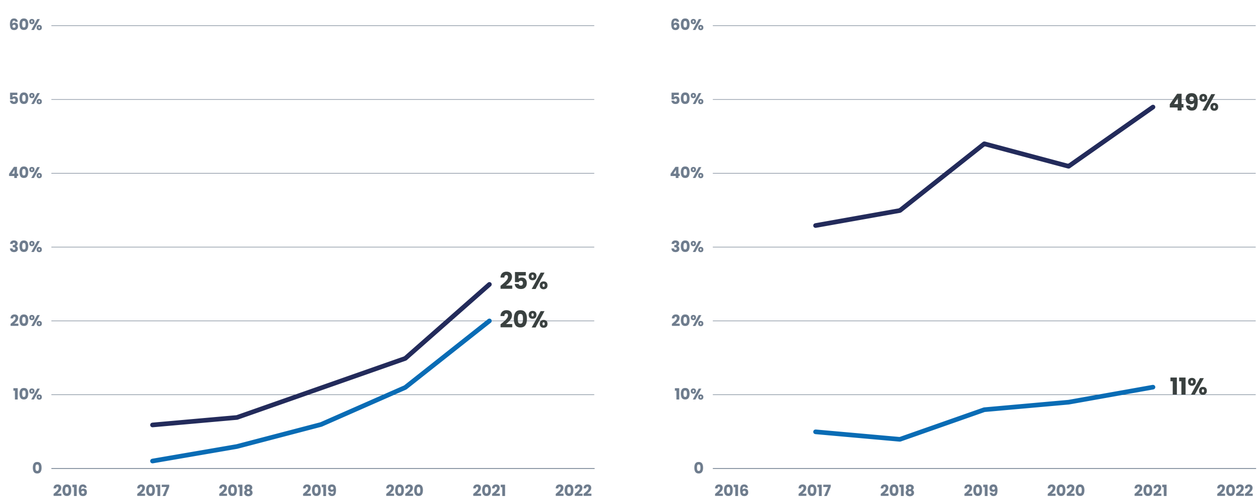
Secondly, an analysis was made to determine which is the most popular non-financial metric used by companies in short- and long-term incentive plans. It shows that employee-related measures are used by 49 per cent of companies in their short-term incentive metric, while the most used metric in the long-term incentive structure is the environment (20 per cent of sample companies). The 5-year evolution of the environmental and employee-related measures in short- and long-term incentives is shown in Figure 3:

Figure 3:

Short-term incentives Long-term incentives

Occurrence of environmental measures in incentives

Occurrence of employee-related measures in incentives



Source: Candriam, Vlerick Business School

Zooming in on environmental measures, carbon emission levels are used by 18 per cent of companies that include the measure in their short- and long-term incentives. Carbon emissions levels are the most used environmental measure, ahead of energy, rating, waste, water and packaging.

On the other hand, health and safety and employee satisfaction are the most used indicators among employee-related measures in short-term incentives, with 23 and 16 per cent of firms using them, respectively. They are followed by diversity and inclusion indicators, culture, attraction/ succession/ retention and training & development. For long-term incentives, the use of employee-related metrics is rather limited, however, when they are, employee satisfaction and diversity and inclusion are the most used ones.

General strategy and sustainability metrics are used by 44 per cent and 36 per cent of all companies in their short-term plans while what such metrics entail is not always clear and transparent for other stakeholders. The exact KPIs under general sustainability metrics are often not disclosed, and it was seen in the dataset that external rating metrics are also included in this group.

Interestingly, supplier-related metrics are used by a limited number of companies (3 per cent for short-term incentives vs 1 per cent for long-term incentives), even in sectors where the supply chain is key. Examples of such targets are an increasing share of renewable electricity at supplier companies, planning and implementation of projects to strengthen women's rights at supplier factories, safety-related targets, as well as an increase in the number of suppliers who are signatories of a supplier code, and the number of independent external audits of suppliers.

Alignment of KPIs: sector analysis

As stated in the previous section, companies are expected to explain the link between their choices for specific metrics and the ESG risks and targets related to their business activities. Given that the business activities and sector in which the company operates have overlapping fields, we would like to focus on the specific choices made by STOXX Europe 600 companies under this section and to conclude whether specific metrics are more frequently used in some sectors than in others. Sectors of the samples companies are categorized under 11 groups:

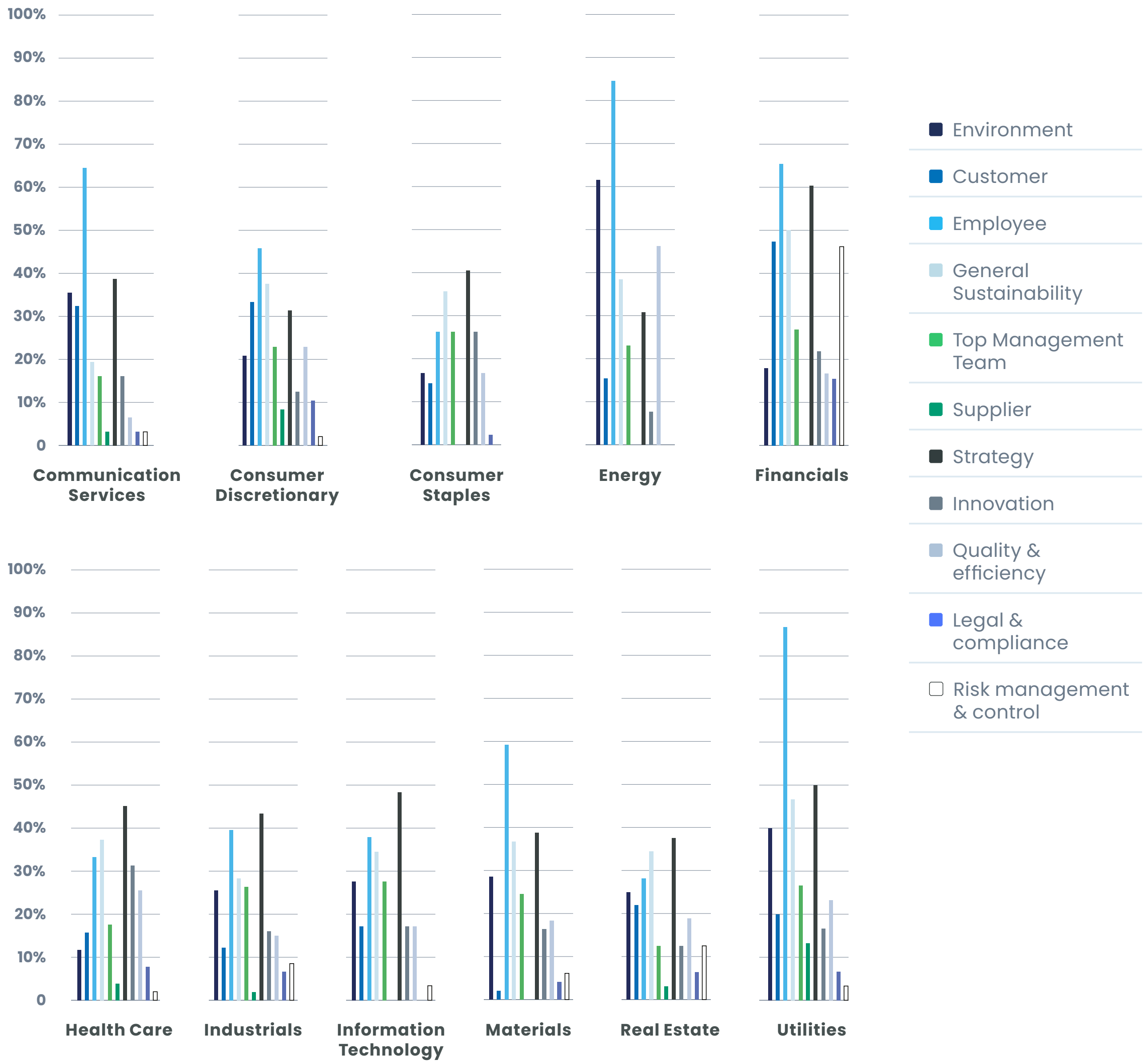
- Communication Services
- Consumer Discretionary
- Consumer Staples
- Energy
- Financials
- Health Care
- Industrials
- Information Technology
- Materials
- Real Estate
- Utilities

To provide a clearer picture, we will focus on short-term and long-term incentive plans separately.

Metrics used in short-term incentive plans based on sector classification

With regards to the short-term incentive plans, the graph hereafter shows the use of each non-financial metric category:

Figure 4:
Use of non-financial metrics in the various sectors in short-term incentive plans

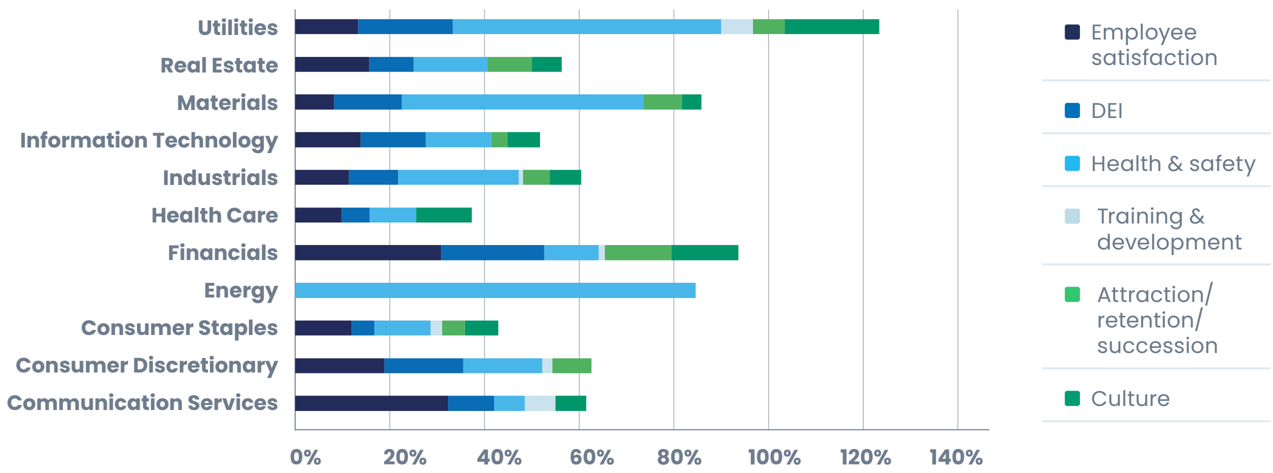


Source: Candriam, Vlerick Business School

Employee-related metrics

Figure 5 shows that employee-related non-financial metrics are used by a significant share of companies regardless of their sector. Such metrics include, but are not limited to, employee satisfaction, diversity, equity & inclusion, health and safety, training and development, attraction/ succession/ retention and culture, while the most frequently used metric varies depending on the sector:

Figure 5:
Use of employee-related metrics in short-term incentive plans



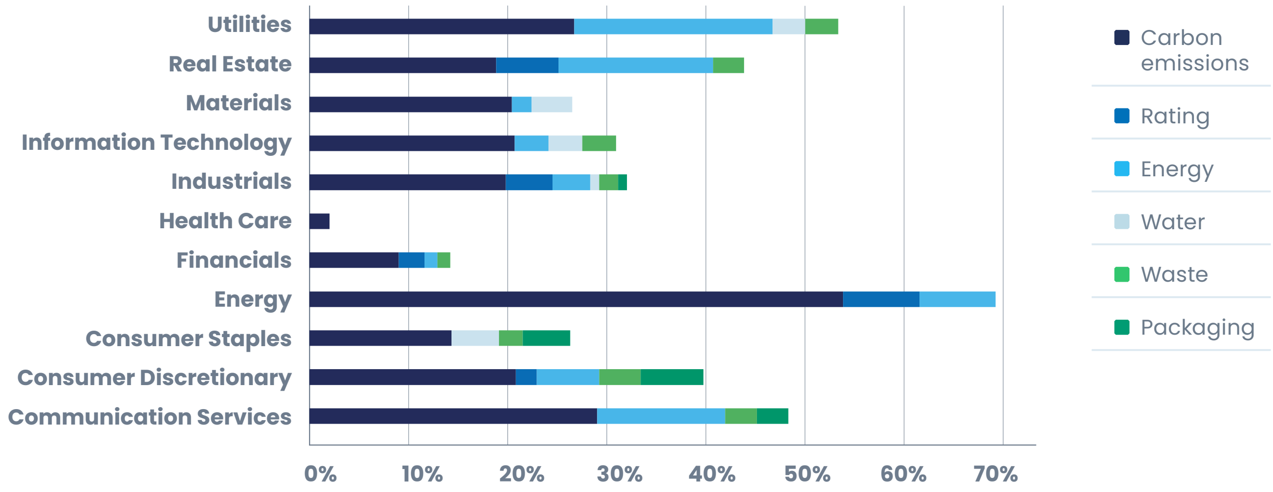
Source: Candriam, Vlerick Business School.
Several metrics may be used, therefore the sum for each sector can be superior to 100%

It is interesting to note that companies from the energy, utilities and materials sectors preferably use health & safety-related metrics such as incident rate, and evolution of TIER 1 and 2 incidents which can be considered material given the working conditions at those companies. On the other hand, employee satisfaction is the preferred metric for companies active in communication services and financials.

Environmental metrics

Environmental metrics include carbon emission levels, rating of companies, energy-related metrics, water, waste and packaging. Figure 6 below confirms that carbon emission targets are used by a significant portion of companies across sectors, probably because they are easier to measure than other environmental targets. However, the achievement of carbon emission targets was criticized in a report published by PwC and the London Business School[10]. This paper assesses the inclusion of ESG metrics in executive remuneration at the 50 largest European listed companies against four criteria: significance, measurability, transparency and demonstrability of the targets. It is observed that only one company is meeting all criteria while the average payout based on carbon targets for 2022 is at 86 percent (half of the companies pay out at 100 percent). This raises questions on the robustness of targets such as the progress on reducing carbon emissions, insofar as the common understanding is that the global progress is not sufficient.

Figure 6:
Use of environmental metrics in short-term incentive plans



Source: Candriam, Vlerick Business School

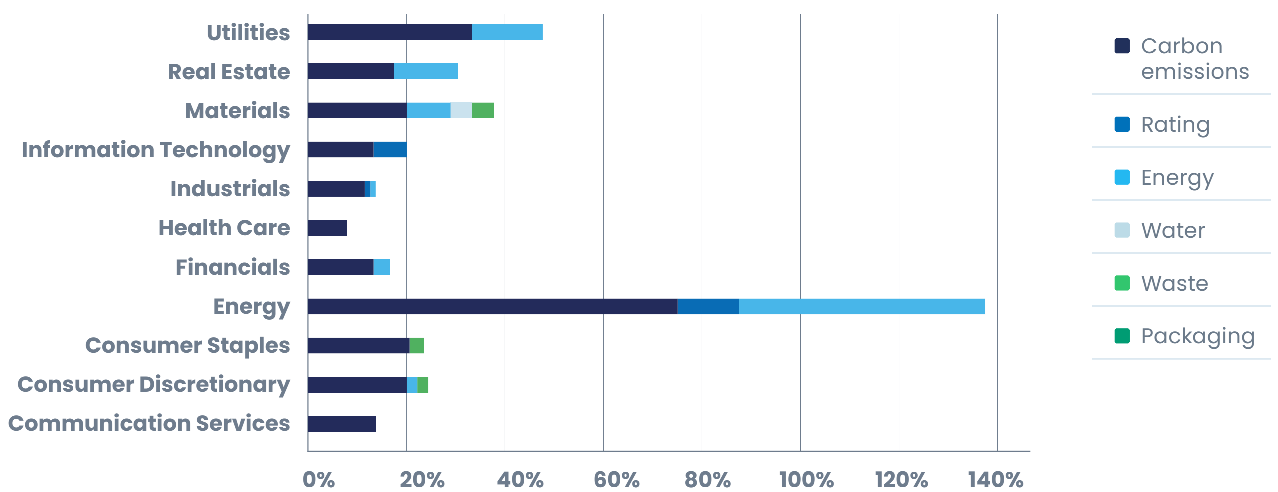
Metrics used in long-term incentive plans based on sector classification

Figure 7:
Use of non-financial metrics in the various sectors in long-term incentive plans

Source: Candriam, Vlerick Business School

In contrast with the metrics used in short-term incentive plans, we see companies in the energy, materials and utility sectors use environment-related metrics in their long-term plans. This may be explained by their long-term commitments to reduce carbon emission levels; instead of setting yearly targets, companies preferably adopt measurable medium- or long-term achievements. Here, it is important to note that energy companies that pledge emission cuts and embed them into their executive remuneration are still being rewarded for increasing production growth. We see companies add metrics that directly incentivize oil and gas production growth despite their net-zero goals and their promises to cut oil production. Investors are scrutinizing these cases as management incentives should be aligned with the realities of the energy transition. Moreover, the scope of climate targets should be in line with the companies' long-term strategy as in most cases, companies set a target for Scope 1-3 emissions while executives are rewarded for a far lesser goal, mainly Scope 1 and 2 only.[11]

Figure 8:
Use of environmental metrics in long-term incentive plans

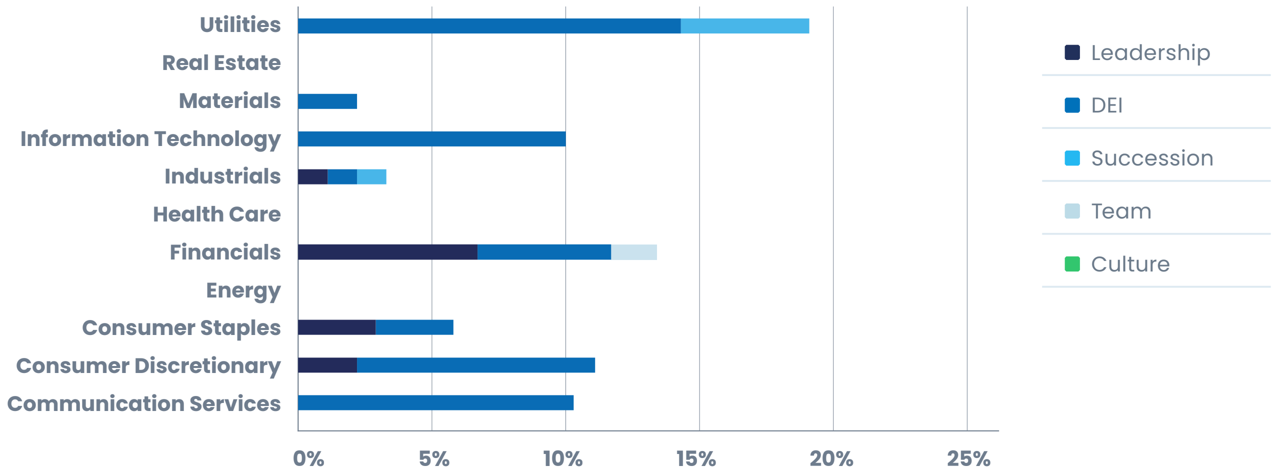


Source: Candriam, Vlerick Business School.
As several metrics may be used, the sum for each sector can be superior to 100%

On the other hand, general sustainability metrics that include external ratings are commonly used across sectors. Companies in the energy and financial sectors prefer to have different risk and management metrics linked to their business activities.

Looking closer at metrics related to top management, as shown in the graph below, diversity, equity and inclusion is still the most frequently used metric across sectors for long-term incentive plans. Succession is preferred by utilities and industrials, which proves once again that succession planning can provide a long-term advantage for companies because of the technical nature of the business and the talent gap.

Figure 9:
Use of metrics related to top-management in long-term incentive plans for the various sectors



Source: Candriam, Vlerick Business School

Candriam analysis on a smaller sample

To confirm the findings for a smaller sample of companies selected by Candriam's ESG sector analysts, the following issuers (40 in total) were analyzed for their selection of non-financial metrics.

Composition of the sample of companies* selected by Candriam

Abertis Infraestructuras SA	Veolia Environnement SA
ABN Amro NV	Nestle SA
Koninklijke Ahold Delhaize NV	Novartis AG
ASML Holding NV	Reckitt Benckiser Plc
Astrazeneca Plc	Renault SA
Bayerische Motoren Werke AG	Repsol SA
Capgemini SE	Richemont SA
Danone SA	Roche Holding AG
Dassault Systemes SE	Compagnie de Saint-Gobain
Deutsche Post AG	Sanofi
Vestas Wind Systems A/S	Sap SE
Engie SA	Schneider Electric SE
Volkswagen AG	SIG Group AG
Intesa San Paolo SpA	Signify NV
Kingspan plc	Société Générale SA
Kone Oyj	Solvay SA
Yara International ASA	Stellantis NV
LVMH Moet Hennessy Louis Vuitton SE	STMicroelectronics NV
Unicredit	Topdanmark 1/S
Moncler SpA	TotalEnergies SE

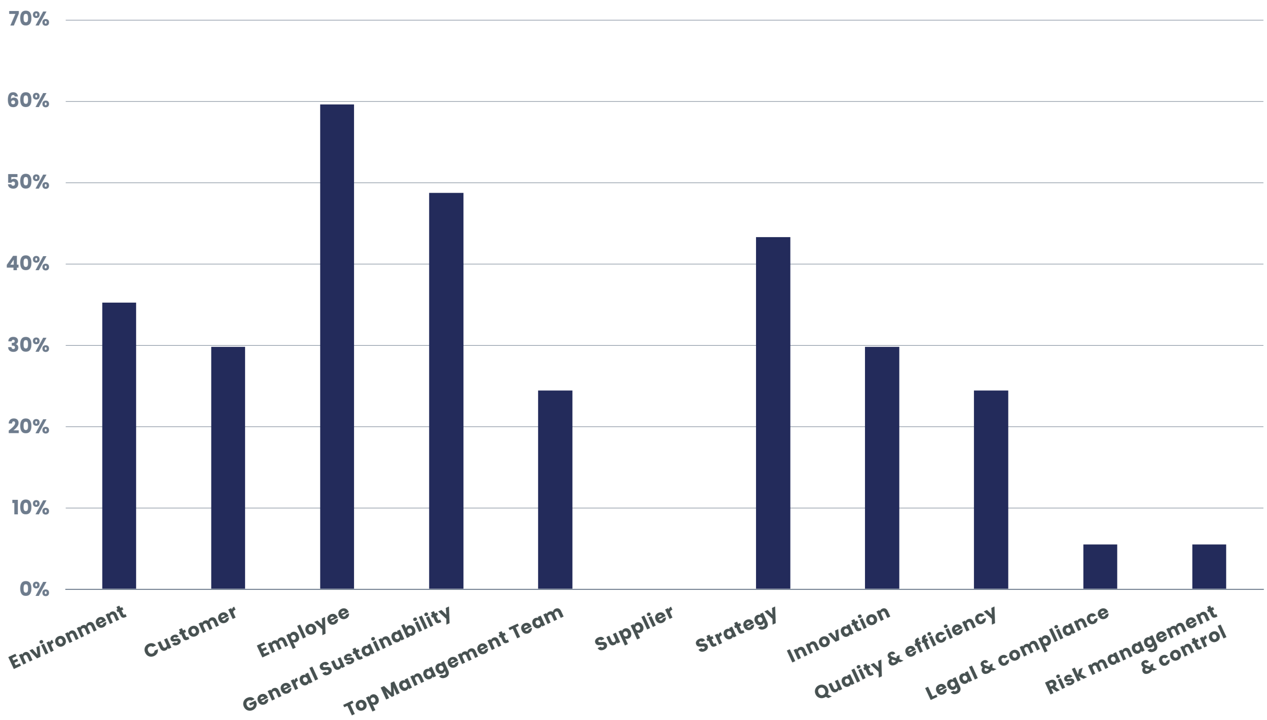
These are portfolio securities.

Candriam's analysts selected companies based on their ESG awareness. The list includes both frontrunners and laggards. We also provide in section 4 a detailed case study for three of these companies, showing how we approach ESG metric inclusion.

* These are portfolio securities.

Going back to the metrics chosen by those 40 companies, employee-related is confirmed to be the most used metric in short-term incentive plans.

Figure 10:
Use of ESG-metrics in short-term incentive plans, reduced sample



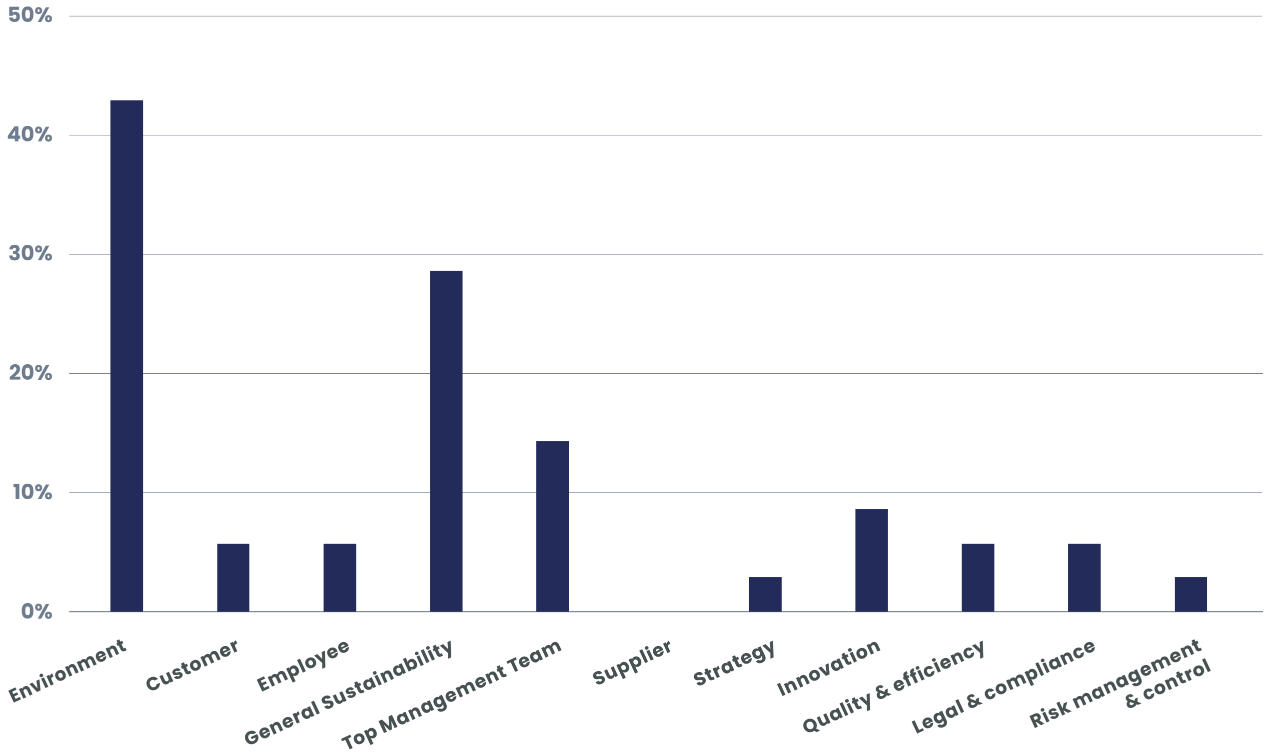
Source: Candriam , Vlerick Business School

Employee satisfaction, being easy to track and measure, is the most preferred metric and the main category chosen by 32.4 per cent of companies. In this part, it is worth mentioning that issuers are expected to report on the KPIs they use to assess employee satisfaction, on which internal departments are in charge of conducting such assessment, and on whether this score is externally audited.

Employee-related metrics are followed by general sustainability and strategy metrics, and the potential reasons for these selections are the same as for larger companies, as explained above.

In line with the findings above, almost half (43 per cent) of the 40 companies have also chosen to include environmental-related targets in their long-term incentive plans (42.9 per cent), with 43 per cent using carbon emission targets as the main KPIs.

Figure 11:
Use of ESG-metrics in long-term incentive plans, reduced sample



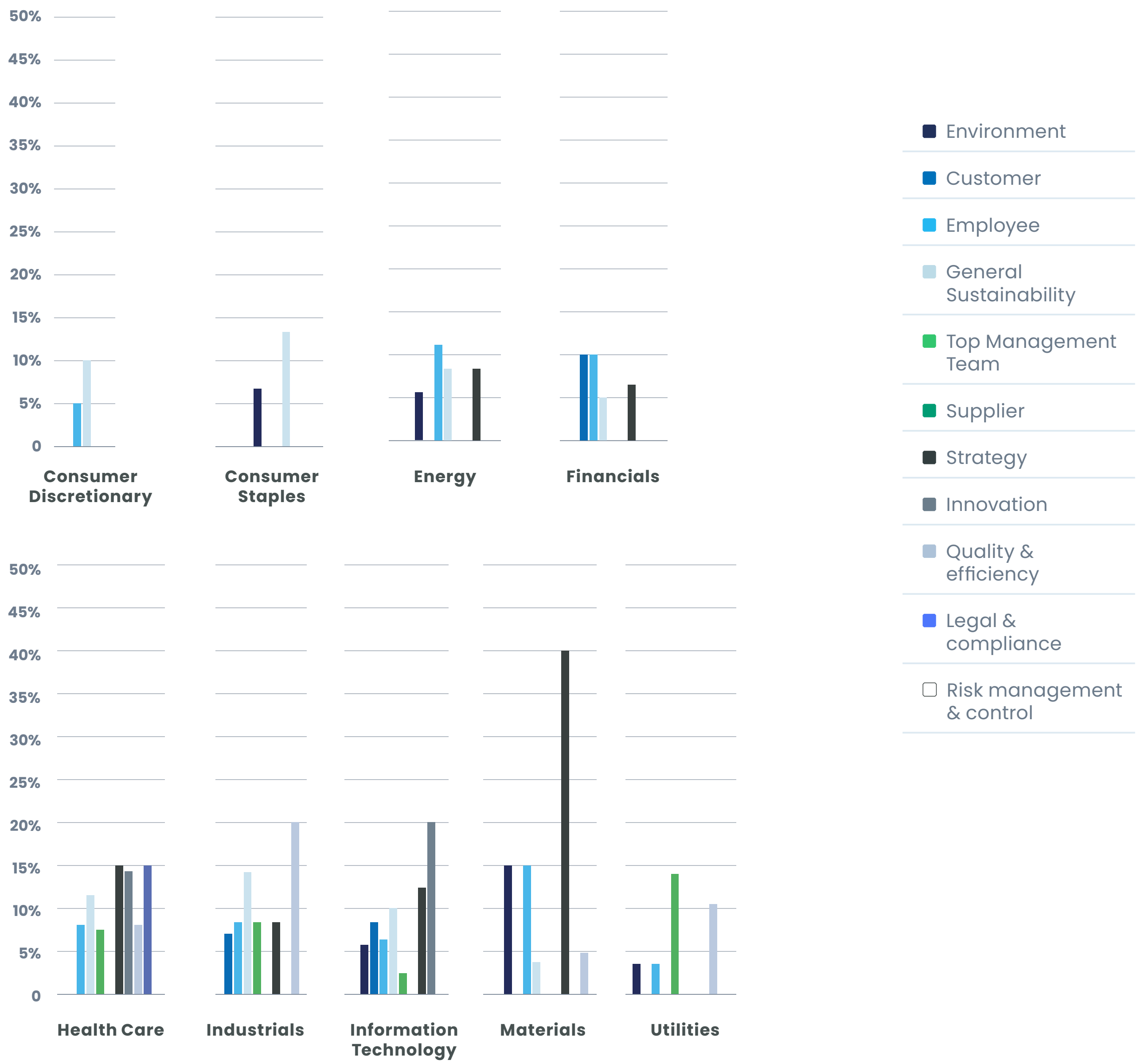
Source: Candriam, Vlerick Business School

Average weighting of metrics used in variable remuneration

To show what the commonly used weightings are for each performance metric, we have taken a closer look at our sample companies.

For short-term incentive plans, we observe that environmental metrics have the highest weightings at materials companies with an average of 15 per cent. The highest weighting detected among all metrics belongs to the overall sustainability strategy with a 40 per cent weighting in the short-term incentive plan. On the other hand, when companies choose several metrics with individual weighting, we observe a typical average weighting between 5-15 per cent.

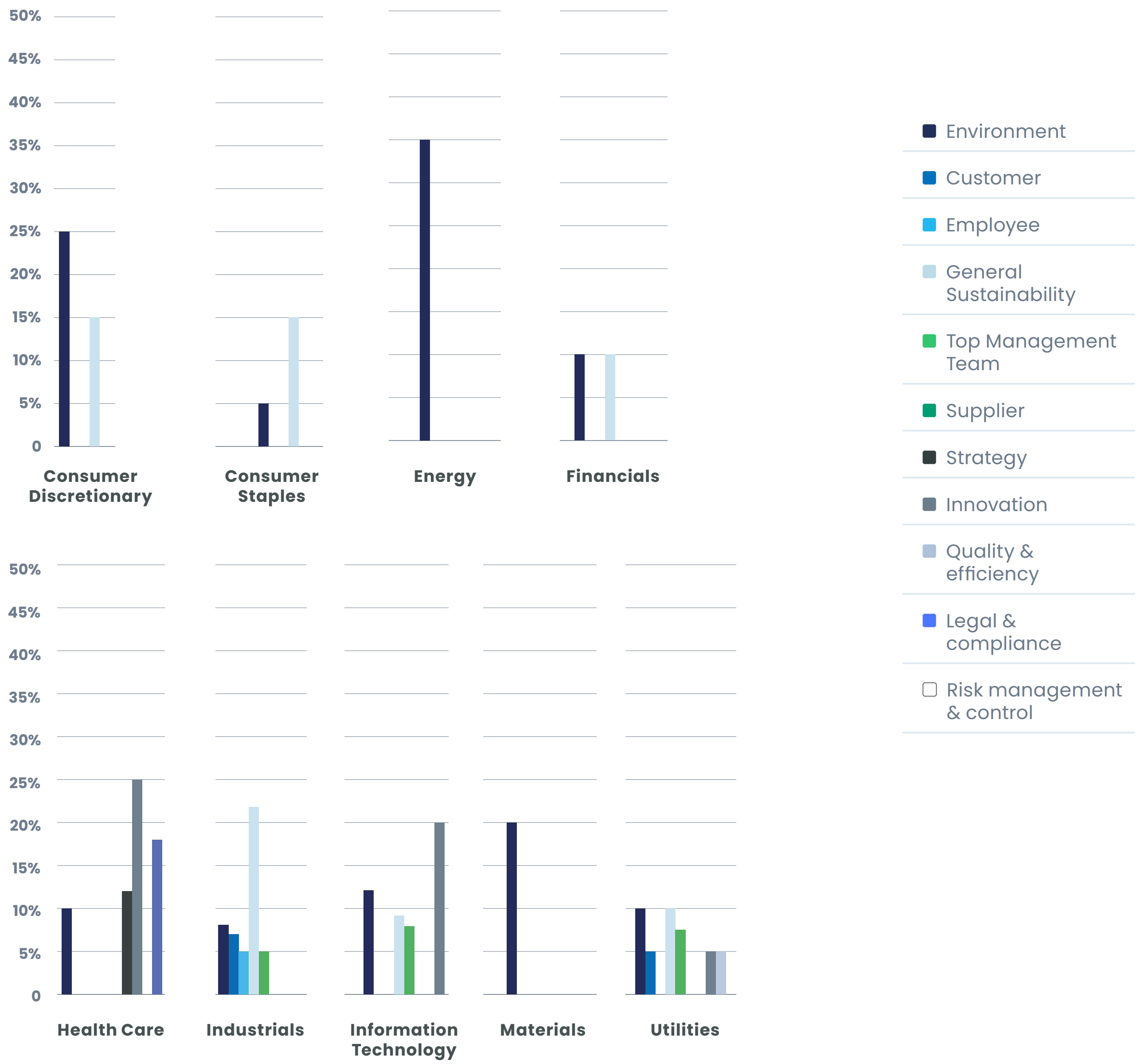
Figure 12:
Average weighting of non-financial metrics in short-term incentive plans



Source: Candriam, Vlerick Business School

Comparing the levels we noted for short-term incentives with the weightings they have in long-term incentive plans, we note that environmental objectives have a higher weighting across sectors.

Figure 13:
Average weighting of non-financial metrics in long-term incentive plans



Source: Candriam, Vlerick Business School

As shown in Figure 13, companies prefer giving higher weightings to each of the non-financial metrics in their long-term incentive plans, and the average weightings vary from 5 to 35 per cent.

The difference in the metrics and weightings could potentially result from the limitations around setting yearly targets for their environmental strategies, as these strategies are mostly multi-year forward-looking plans. On the other hand, social-related metrics (employee, customer, top management, diversity and inclusion) are seen to be more generally included in the short-term incentive plans given their yearly-measurable nature.

Case Studies.

Under this section, we analyze the executive remuneration packages of three companies selected from the Luxury (for the S pillar), Energy (for the E pillar) and Financial sectors (for the G pillar). The analysis is based on the latest available information at the time of writing.

Kering SA*
Luxury Sector

Kering SA's practices of linking ESG performance to the executives' remuneration deserve attention.

Short- and long-term incentives:

Non-financial metrics are included in both short- and long-term plans. Sustainability, corporate social responsibility (CSR) and organization and talent management are used in the short-term plan while the proportion of women in executive management and biodiversity are chosen for the multi-annual variable remuneration.

Weighting:

The company has given a 30 and 20 per cent weighting to the non-financial metrics in its short-term and long-term plans, respectively.

Disclosure and Targets:

The company provides the relevant metrics used in the plans ex-ante. Some criteria, such as sustainability in the short-term incentive plan, are disclosed with a set of achievable objectives (Figure 14).

While some of the targets are transparent, some need more explanation as to how success is measured. Especially for the ethics and enhancing organisation, we find that the company must put more measurable targets (rather than quantitative metrics on enhancing efficiency) to better communicate how the performance is assessed for these KPIs and what a 100 per cent achievement corresponds to.

On the other hand, we observe that the targets are set with measurable and clear objectives under the long-term incentive plan (Figure 15).

* This is a portfolio security.

Figure 14:

Extract of Kering's Universal Registration Document relative to metrics used in the short-term incentive plan

Non-financial criteria	2022 targets	Weighting
Sustainability	**Objective: Sustainability and, more particularly, a reduction in Kering's environmental impact, in line with the strategy for 2025** • continue to embed an active sustainability culture across all Group entities and supply chains; • eliminate single-use plastics from BtoC packaging; • step up and run sustainability partnerships and initiatives in conjunction with universities; • add more ESG indicators to the existing list; • lead the Fashion Pact, positioning Kering at the vanguard of the international industry and attracting new members; • establish and lead the Watches and Jewellery Initiative 2030 coalition. **Objective: Ethics** • strengthen the culture of ethics within the Group; • conduct internal communication initiatives to promote this culture; • increase the number of employees who have completed the new Code of Ethics e-learning module.	10%
Corporate social responsibility	**Involvement of executive corporate officers through regular communication about compliance issues, to provide real leadership:** The Chairman and Chief Executive Officer and the Group Managing Director must issue at least one compliance-related message every year, emphasizing the importance to the Group of having a Culture of Integrity. This message must be supported by an equivalent message from the Houses' CEOs.	10%
Organization and talent management	**Commitment by the executive corporate officers demonstrating by championing, supporting and leading initiatives to:** • increase diversity in the workforce, with a particular emphasis on achieving gender balance; • ensure succession plans are in place for Executive Committee members and key positions, as well as talent development overall; • entrench Kering's culture and values and to enhance organizational efficiency and ensure the Group remains in step with new business priorities and changing external conditions.	10%
Sub-total		**30%**
TOTAL		100%

Source : Kering[12]

Figure 15:

Extract of Kering's Universal Registration Document relative to metrics used in the long-term incentive plan

Criteria	Relative weighting	Performance assessment method
Consolidated recurring operating income	40%	Increase observed between the average amount over the three-year vesting period and the amount observed for the year preceding the year of the grant • No increase: 0 shares • Increase < 5%: 50% of the shares relating to the criterion • Increase ≥ 5%: 100% of the shares relating to the criterion
Consolidated free cash flow from operations	40%	Increase observed between the average amount over the three-year vesting period and the amount observed for the year preceding the year of the grant • No increase: 0 shares • Increase < 5%: 50% of the shares relating to the criterion • Increase ≥ 5%: 100% of the shares relating to the criterion
Proportion of women in executive management roles	10%	Lift the proportion of women in Top 450 roles to 48% by 2024 • Proportion < 40%: 0 shares • Proportion between 40% and 48%: 50% of the shares relating to the criterion • Proportion ≥ 48%: 100% of the shares relating to the criterion
Biodiversity	10%	Switchover to regenerative agriculture practices by 2024 on 400,000 hectares of land linked to Kering's supply chain and protection of 500,000 hectares in key areas that are not part of the supply chain • No targets met: 0 shares • One target met: 50% of the shares relating to the criterion • Both targets met: 100% of the shares relating to the criterion
Sub-total	**100%**	
Kering share performance	+/-50% impact	• < target: up to -50% • Equal to target: 0% • > target: up to +50% See below for details
TOTAL	50% TO 150%	

Source : Kering

Alignment:

Candriam believes that the company has ambitious environmental targets and a clear and comprehensive strategy, which is rare in the sector. Disclosures on supply chain risks and human capital management are well-managed while some metrics are lacking on supply chain mapping or actions to curb PETA's accusation over exotic leather.

Kering's choices of non-financial metrics in the short-term plan can be considered relevant to their company strategy. Notably, reducing its environmental impact through eliminating single-use plastics from BtoC packaging, ensuring sustainability across the supply chain, increasing diversity in the workforce and ensuring robust succession planning is in line with the company's Sustainability Roadmap[13]. The diversity-related targets are embedded in the 2025 Sustainability Strategy as Kering is promoting diversity and gender equality through a series of concrete commitments, which include ensuring salary equity in all functions, achieving gender parity at all levels and introducing a mentoring program for women at the international level. Moreover, the company has also set a 2025 strategy that encompasses 6 main targets ranging from 100% traceability of raw materials to reducing its environmental profit and loss account (EP&L) intensity by 40% by 2025 (vs 2015) and becoming a nature-positive company by 2025.

With regards to the metrics in the long-term plan, the biodiversity target under the company's Regenerative Fund for Nature[14] is linked to the executives' remuneration to promote better alignment. The Regenerative Fund for Nature aims at transforming 1,000,000 hectares of crop and rangelands into regenerative agricultural spaces over the next five years.

Lastly, what stands out for Kering is its environmental profit & loss (EP&L) tool which is used for quantifying the environmental impact of the business activities. The EP&L data is audited by third-party statutory auditors to ensure the robustness of the process and the quality of data and is published together with the financial results of the corresponding financial year. This tool is an example of translating environmental impacts into a more measurable language.

Performance assessment:

The company provides the overall achievement of each performance metric in percentage and a detailed explanation of the achievement milestones for each metric in the Universal Registration Document[15]. While the disclosure level is above market practices, the document still lacks the key information on the assessment of KPIs versus the targets set at the beginning of the cycle, as the targets for several KPIs need more concrete and measurable objectives.

Conclusion:

Overall, we reach the following conclusion:

Elements to consider	Questions to Ask	Answers
Short- and long-term incentives	1. Is the chosen time horizon in line with the business strategy?	**Yes**
Weightings	2. Is the weighting given to each metric challenging and relevant for the company?	**Yes**
Disclosure & Targets	3. Does the company provide clear disclosure on the rationale for selecting ESG metrics?	**Yes**
	4. Is the disclosure of the reasons behind the choice of metrics and targets clear and understandable?	**Yes**, mostly (see above feedback on targets)
	5. Is the metric clear, measurable, challenging, forward-looking and attainable?	**Yes**
Alignment	6. Is the ESG metric relevant to the company's ESG strategy?	**Yes**
Performance assessment	7. Does the company provide sufficient disclosure on the assessment of each performance metric and its achievement?	**Yes**, mostly (see above feedback on targets)
	8. Does the company explain the discretion used if any?	**Yes**

Enel Group*
Utilities Sector

On this company from the Utilities sector, we aim to further analyze the inclusion of environmental targets in the companies' variable remuneration schemes.

Short- and long-term incentives:

Non-financial metrics are included in both the company's short- and long-term plans.

The short-term plan includes the following metrics: reduction of the work-related accident frequency index (FI) in 2022 vs the average of the results of the previous three-year period, number of fatal accidents in 2022 at a similar or lower level than the previous year's target, level of the commercial complaints and System Average Interruption Duration Index- SAIDI).

The long-term plan includes GHG Scope 1 emission and the percentage of women in top management succession plans at the end of 2024.

Weighting:

The performance metrics included in the company's short-term plan have a 30 percent weighting in the total. In the long-term plan, non-financial metrics account for 20 percent of the total award.

Considering the company's decarbonization objectives and new energy solution targets, the variable remuneration's weightings are deemed reasonable.

Disclosure and Targets:

Each year the company provides, through the Report on the Remuneration Policy and Compensation Paid, details about the achievement of targets for the previous year and around future targets, for each performance criterion. Overall, it is noted that the performance is below the threshold for the reduction of the work-related accident frequency index in the short-term plan. As regards the 2019-2021 long-term plan, the level of CO_2 emissions produced by the group in 2021 is at the 'over-performance' level, which highlights the acceleration of Enel's decarbonization strategy, a result of the group's increased ambition, pinpointed by more and more stringent emission reduction targets set in the last two years. In the meantime, it also raises a question from the investors' side on whether the set targets are challenging enough for the company.

* This is a portfolio security.

Figure 16:
Extract from Enel's 2022 remuneration report

Short-term variable remuneration

Performance objectives assigned to the CEO/GM	Access threshold	Target objective	Maximum objective	Achieved performance	Access threshold payout	Target payout	Maximum payout	Achieved payout
Ordinary consolidated net income	5,410 €Mln	5,460 €Mln	5,570 €Mln	5,538 € Mln (*)	17.5%	35%	52.5%	47.7%
Group Opex	7,970 €Mln	7,890 €Mln	7,810 €Mln	7,852 €Mln (**)	10%	20%	30%	25.3%
Funds from operations/ Consolidated net financial debt	24.22%	24.46%	24.95%	22.35% (***)	7.5%	15%	22.5%	0%
System Average Interruption Duration Index - SAIDI	255 min	252 min	247 min	243 min	7.5%	15%	22.5%	22.5%
Reduction of the work-related accident frequency index (FI) 2021 *vs* the average of the results of the previous three-year period and concurrent reduction in the number of fatal accidents 2021 *vs.* target of the previous year	Work-related accident frequency index (FI) 2021< 0.64 and fatal accidents 2021 < target of the Group's fatal accidents in 2020	FI 2021< 0.60 and the same objective for the reduction of the number of fatal accidents in 2021 provided for the access threshold	FI 2021< 0.46 and the same objective for the reduction of the number of fatal accidents in 2021 provided for the access threshold	FI = 0.43 Objective to reduce the number of fatal accidents in the reporting period not achieved (****)	7.5%	15%	22.5%	0%
Total Payout					50%	100%	150%	95.4%

Long-term variable remuneration

Performance objectives assigned to the beneficiaries of the LTI Plan 2019 (CEO/GM)	Target objective	I Over objective	II Over objective	Achieved performance	Target payout	I Over payout	II Over payout	Achieved payout
Average Enel TSR *vs* average TSR of EUROSTOXX Utilities Index – EMU over the three years 2019-2021	Between 100% and 110%	Between 110% and 115%	More than 115%	104.6%	50%	75%	140%	61.5%
Cumulative return on average capital employed (ROACE) over the three years 2019-2021	38.1%	38.6%	39.2%	37.9%	40%	60%	112%	0%
CO_2 emissions (data in gCO_2/kWheq) produced by the Group in 2021	<=345	<=335	<=325	222	10%	15%	28%	28% (*)
Total Payout					100%	150%	280%	89.5%

Source: Enel

In addition, we acknowledge that the company reviews and amends its targets on a yearly basis to maintain their relevance and materiality for both the short- and long-term plans. As an example, for the 2022-24 long-term plan, the weighting of the gender equality objective (percentage of women in top management succession plans) was increased to 10 percent (from 5 percent) to promote the reduction of the gender gap within the group.

Alignment:

We note that the company explicitly committed to aligning capex to a 1.5 °C scenario and to fully decarbonizing by 2040, bringing forward its previous net-zero target by a decade. In order to meet this target, Enel has committed to generating and selling energy exclusively from renewable sources by 2040. In order to stay aligned in the future, the company has implemented an extensive environmental strategy with a target of reducing direct CO_2 emissions from generation activities to 72 gCO_2eq/kWh by 2030, down 80% compared with 2017 - relevant with a scenario that limits global warming to 1.5 °C compared with pre-industrial levels, as certified by the Science Based Targets initiative (SBTi) - and achieving full decarbonization of its asset base in 2040. Enel's emission reduction targets include both direct and indirect emissions. The group has publicly disclosed targets across its entire value chain, setting 2030 targets for Scope 1, 2 and 3 emissions that have been certified by the SBTi in line with the 1.5 °C pathway and committing to Net Zero by 2040 across its entire value chain, including Scope 1, Scope 2 and Scope 3 emissions.

This being said, we still raise some level of concern about linking only Scope 1 emissions to the executive remuneration, as Scope 1 emissions represent only 40% of the company's total GHG emissions.

For the diversity metric, we acknowledge that the criterion focuses on top management succession plans for about 300 positions and is intended to create a pipeline for the turnover of top positions to also promote foreseeability on the business continuity. It is in line with the company's diversity and inclusion objectives of maintaining 50% female participation in selection processes.

Lastly, with regards to the accident frequency index metric, it is considered relevant since safety at work is a material topic for utilities companies. In addition, they included the contractors in the target, which we regard as positive.

Performance assessment:

At the beginning of its remuneration report[16], the company provides explanations of the calculation method for each non-financial metric, which gives a better understanding of the feasibility of the set targets.

Conclusion:

Overall, we can conclude the following points about the company's executive remuneration package:

Elements to consider	Questions to Ask	Answers
Short- and long-term incentives	1. Is the chosen time horizon in line with the business strategy?	**Yes**
Weightings	2. Is the weighting given to each metric challenging and relevant for the company?	**Yes** (See in addition the above feedback on the above-target achievement)
Disclosure & Targets	3. Does the company provide clear disclosure on the rationale for selecting ESG metrics?	**Yes**
	4. Is the disclosure of the reasons behind the choice of metrics and targets clear and understandable?	**Partially** (See the above feedback on the scope of the targets)
	5. Is the metric clear, measurable, challenging, forward-looking and attainable?	**Mostly** (See the above feedback on the scope of the targets & GHG Emission Scope)
Alignment	6. Is the ESG metric relevant to the company's ESG strategy?	**Partially** (See the above feedback on the GHG Emission Scope)
Performance assessment	7. Does the company provide sufficient disclosure on the assessment of each performance metric and its achievement?	**Yes**
	8. Does the company explain the discretion used if any?	**Yes**

Lloyds Banking Group*
Banking Sector

Our third case study is Lloyds Banking Group.

Short- and long-term incentives:

Non-financial metrics are included in both short- and long-term plans. The short-term plan includes 3 metrics:

1/ climate: reducing operational carbon emissions & sustainable financing and investment

2/ colleague: increasing gender and ethnic representation in senior roles & Culture and Colleague Engagement

3/ customer dashboard

The long-term plan consists of 2 metrics:

1/ strategic measures and

2/environmental measures.

Weighting:

The company has given a

- 45 per cent weighting to non-financial metrics in the short-term and
- 50 per cent weighting to non-financial metrics in long-term plans.

The breakdown for the short- and long-term plans is disclosed:

Short-term (Group Performance Scorecard)

Non-financial (45%)	**Customer** Our assessment of how effectively we are serving customers across all brands, products and services	**20%**
	Colleague - Increasing our gender and ethnic representation in senior roles - Culture and colleague engagement	**7.5%** **7.5%**
	Climate - Reducing our operational carbon emissions - Sustainable financing and investment	**5.0%** **5.0%**

Source: Lloyds Banking Group

Long-term

Awards will be weighted 50% to non-financial measures, with:

- 35% anticipated for strategic measures and
- 15% to environmental measures,

reflecting that the transition to a low-carbon economy is at the core of the company's strategy and aligns with their purpose to "Help Britain Prosper".

Disclosure and Targets:

Targets will be disclosed retrospectively in the 2023 annual report alongside the level of performance achieved, as the Remuneration Committee considers such targets to be commercially sensitive. Nevertheless, a target range has been set in line with the operating plan and, where applicable, forward-looking guidance.

* This is a portfolio security.

Figure 17:
Extract of Lloyds Banking Group's 2022 annual report – Commentary on non-financial measures

Measure	Commentary
Group customer dashboard Our assessment of how effectively we are serving customers across all brands, products and services	In 2022, 80 per cent of Group customer dashboard measures achieved target, reflecting strong performance relative to peers, with average rank position further improved year on year. Continued focus is required to maintain strong position in market and to further improve absolute scores across customer experience measures
Reducing operational carbon emissions	A 33 per cent reduction in emissions has been achieved in 2022 from our 2018/19 baseline. Year on year reductions in gas and refrigerants have been delivered, although increases have been seen in commuting and business travel emissions as colleagues return to offices
Sustainable financing and investment	• We have exceeded our Sustainable finance and investment metric with strong performance across all contributing business lines – Commercial Banking, Consumer Lending Mortgages, Consumer Lending Transport and Scottish Widows Investments • Demand has increased for sustainable finance supported by a strong housing market earlier in the year and the increasing take up of electric vehicles. Continued strengthening of our sustainable finance teams helped us secure more transactions including a number of Sustainability Linked Loan co-ordinator roles. Investments in climate-aware strategies were always planned to deliver a greater proportion upfront towards the overall 2025 strategic outcome, but performance in 2022 also benefitted from conversion of some investment in property shares to a low carbon tilt and an earlier than anticipated launch of the BlackRock ESG Credit Insight fund
Increasing our gender and ethnic representation in senior roles	• We have increased the representation of women within our senior population by 1.7 percentage points since the end of 2021, moving from 37.7 per cent to 39.4 per cent • We have increased the representation of Black, Asian and Minority Ethnic colleagues by 1.4 percentage points since the end of 2021, moving from 8.8 per cent to 10.2 per cent
Culture and colleague engagement Our employee engagement index score absolute and performance versus UK norm and high performing norm	• Engagement saw a positive increase to 75 per cent in 2022 which is +6 points higher than the UK average though 3pts below the UK high performing norm (comparisons from 2019–2021) • We also saw an increase in advocacy/eNPS (a new measure introduced in 2022) and colleague mood, with continued positive perceptions of our line manager capability

Source: Lloyds Banking Group

Alignment:

Candriam believes that the chosen ESG metrics are in line with Lloyds ESG strategy. The bank continues to lead global peers on corporate governance – it has an independent majority board and has established a responsible business committee to support the board in ESG matters. One Lloyds' focus point is *ethnic and gender representation* on the board and senior roles, and the metric is material since the UK Code recommends companies adopt policies on gender, social and ethnicity diversity at the board level. Even though there is no quota requirement (except for the female representation of 33%), this topic is becoming more and more sensitive in the UK.

Regarding the metric *Sustainable financing and investment*, it is relevant and material because scope 3 emissions are becoming more and more important for the banking sector, with the regulation demanding additional disclosure on the loan book. The impact of climate change on the financial sector is already in dollar billions, only accounting for extreme weather events. Adding other elements, such as credit risks for banks, delays in the fight against climate change could cost institutions up to $1.2 trillion over the next 15 years[17]. By the choices they make, investment and financing banks shape a model of society. By bringing financial support to companies, projects, individuals or States, banks are responsible for greenhouse gas emissions.

The financial sector lacks transparency on climate risk and the methods used to measure it. The transparency of banks regarding their loans, financing and investments continues to be sub-optimal as it stands, making it very difficult to differentiate between the players. Progress has been made in this direction: financial institutions are subject to increasing pressure, sometimes from regulators, to demonstrate the decarbonization of their portfolio of loans and financing and the reduction of investments offered to the most intensive CO_2 emitting industries.

Initiatives are multiplying (e.g. COP 21 in 2015 and the Task Force on Climate-Related Financial Disclosures - TCFD), adding to the pressure on banks. In addition, the European Central Bank threatens to publish the names of the most recalcitrant institutions under the climate challenge. The European Banking Authority (EBA) has published a draft Implementing Technical Standard (ITS) about the information on ESG risks that banks will have to present within the Pillar 3 framework.

This publication is the latest in a series of initiatives at the EU level, within the framework of the presentation of ESG risks. Banks need to gain a comprehensive and common understanding of how these various initiatives fit together in order to identify synergies and dependencies between the different requirements.

Performance assessment:

As set out in the scorecard assessment table hereafter.

For 2022, ESG metrics aligned to Lloyds's public commitments on climate change and promoting inclusion and diversity accounted for 17.5 per cent of the scorecard. Customer and ESG measures have resulted in an overall outcome of 84.1 per cent.

For the 2023 Group performance scorecard: quantitative financial measures make up 55 per cent of the scorecard, with the remaining 45 per cent made up of non-financial measures assessed by the Remuneration Committee using quantitative inputs.

Figure 18:
Lloyds Banking Group 2022 balanced scorecard

Our 2022 balanced scorecard

Block	Measure	Weighting	Performance Range 25%	50% (Target)	75%	100%	Actual	Outcome	Weighted outcome
Financial (50%)	Profit after tax	20%	£3,765m	£4,236m	£4,706m	£5,177m	£5,555m	100%	20%
	Return on Tangible Equity	20%	8.3%	9.3%	10.3%	11.4%	13.5%	100%	20%
	Operating Costs (excl. remediation and in year GPS expense)	10%	£8,482m	£8,398m	£8,314m	£8,230m	£8,342m	66.5%	6.6%
Non-Financial (50%)	Group customer dashboard	25%	60%	70%	80%	90%	80%	75%	18.8%
	Reducing our operational carbon emissions	5%	20%	32%	35%	37%	33.0%	50%	2.5%
	Sustainable financing and investment	5%	£9,000m	£13,500m	£17,000m	£21,000m	£26,626m[1]	100%	5.0%
	Increasing our gender and ethnic representation in senior roles	3.75%	37.7%	38.4%	39.1%	39.9%	39.4%	75%	2.8%
		3.75%	8.8%	9.4%	9.9%	10.5%	10.2%	75%	2.8%
	Culture and colleague engagement	7.50%	≥ 70 (& above average)	≥ 73 (& ≥ 2 pts above average)	≥ 75 (& ≥ 5 pts above average)	≥ 76 (& above high performing norm)	75 (+6 pts above average)	75%	5.6%
	Total balanced scorecard outcome								**84.1%**

Risk

Source: Lloyds Banking Group

Conclusion:

Overall, we reach the following conclusion:

Elements to consider	Questions to Ask	Answers
Short- and long-term incentives	1. Is the chosen time horizon in line with the business strategy?	**Yes**
Weightings	2. Is the weighting given to each metric challenging and relevant for the company?	**Yes**
Disclosure & Targets	3. Does the company provide clear disclosure on the rationale for selecting ESG metrics?	**Yes**
	4. Is the disclosure of the reasons behind the choice of metrics and targets clear and understandable?	**Yes**
	5. Is the metric clear, measurable, challenging, forward-looking and attainable?	**Yes**
Alignment	6. Is the ESG metric relevant to the company's ESG strategy?	**Yes**
Performance assessment	7. Does the company provide sufficient disclosure on the assessment of each performance metric and its achievement?	**Yes**
	8. Does the company explain the discretion used if any?	**Yes**

Conclu-
sion.

Conclusion: Still work in progress.

This paper points out the importance of tying non-financial business performance to executive remuneration in a world where success cannot be measured only financially. We need to identify the key challenges for the business that may impact financial growth, and hold executives accountable for their failure to address non-financial risks. On the other hand, it is also proven that tying executive remuneration to non-financial objectives also has an impact on financial growth. The most significant progress was found in companies' use of diversity, equity & inclusion (DEI) goals, which rose from 35 percent in 2020 to 51 percent in 2021. In parallel, with the ever-growing attention to climate change, the share of S&P 500 companies that tied carbon footprint and emission reduction goals to executive pay also grew from 10 percent in 2020 to 19 percent in 2021[1].

It is noteworthy that the importance and necessity of including such metrics are still not fully understood by companies despite growing public interest and pressure. Companies are still looking for relevant metrics, with the support of the investment community. Overall, we estimate that with more companies disclosing their ESG priorities and linking their executives' remuneration to ESG performance, the broader use of relevant, measurable, challenging ESG metrics will allow to identify companies' concrete progress and sort out the leaders from the ones lagging behind.

Notes & References.

1 Linking Executive Compensation to ESG Performance: *Linking Executive Compensation to ESG Performance*, https://corpgov.law.harvard.edu/2022/11/27/linking-executive-compensation-to-esg-performance/

2 The double materiality process prescribes that companies should consider the materiality of an ESG issue if it has:

1/ an inside-out impact (impact-perspective) which is related to the significant impacts that the organization can have on people or the environment. The impacts of business activities on the environment include, for instance, impact of air emissions or groundwater pollution due to the release of contaminated slurry from settling basins.

2/ an outside-in impact (financial-perspective) which is related to the financial risks and opportunities that sustainability matters can have on the organization. The impacts of environmental topics on the company include, for example, the strategic importance of the energy transition with reference to energy price changes.

See Also: Double Materiality Guidelines (efrag.org)

3 Source: Forbes

4 Source: Real ESG Accountability: Tying Your Company's ESG Performance to Leadership Compensation, Sustainalytics

5 Source: Sustainalytics

6 https://www3.weforum.org/docs/WEF_IBC_Measuring_Stakeholder_Capitalism_Report_2020.pdf

7 Harvard Law School Forum on Corporate Governance, 2021 ESG+ Incentives Report by John Borneman, Tatyana Day, and Kevin Masini, Semler Brossy Consulting Group LLC

8 ESG - The Long View Does sustainability pay? ESG in executive remuneration, 22/11/2021

9 See Schneider Electric SE

10 Source: PwC and the London Business School, https://www.pwc.co.uk/human-resource-services/pdf/paying-for-net-zero-using-incentives-to-create-accountability-for-climate-goals.pdf

11 Crude Intentions: How oil and gas executives are still rewarded to chase fossil growth, despite the urgent need to transition - Carbon Tracker Initiative, https://carbontracker.org/reports/crude-intentions/

12 Page 139 of Kering's 2021 Universal Registration Document, https://www.kering.com/assets/front/documents/Kering_2021_Universal_Registration_Document.pdf

13 https://www.kering.com/en/sustainability/crafting-tomorrow-s-luxury/2017-2025-roadmap/

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16 https://www.enel.com/content/dam/enel-com/documenti/investitori/governance/remunerazione/en/remuneration-report_2022.pdf

17 Source: BankTrack

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