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Combating climate change through executive compensation

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By Shai Ganu and Philipp Geiler | September 30, 2020

As companies focus on their ESG priorities, explicit linkages to executive incentive plans could help accelerate reduction in greenhouse gas emissions.

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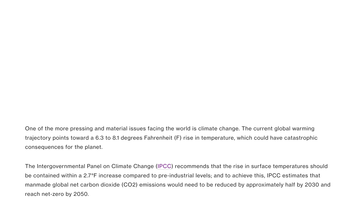


One of the more pressing and material issues facing the world is climate change. The current global warming trajectory points toward a 6.3 to 8.1 degrees Fahrenheit (F) rise in temperature, which could have catastrophic consequences for the planet.

The Intergovernmental Panel on Climate Change (IPCC) recommends that the rise in surface temperatures should be contained within a 2.7°F increase compared to pre-industrial levels; and to achieve this, IPCC estimates that manmade global net carbon dioxide (CO2) emissions would need to be reduced by approximately half by 2030 and reach net-zero by 2050.

Translating these global targets to a national or industry level is not easy. Indeed, at some stage this may warrant interventions from regulators and policymakers, but until then organizations have a responsibility to try to reduce their CO2 and other greenhouse gas (GHG) emissions. Not only is this the right thing to do, but it has the potential upside of enhancing technological innovation, customer stickiness, employee branding and access to green capital. However, reduction of CO2 emissions is quite complex and requires changes to systems, technologies and employee mindsets. These changes can add to costs and require companies to rebase their revenue and margin expectations.

Role of executive compensation as a change agent

This is where executive compensation can play an important role. Incentive plans have proven to be an effective tool to focus management's efforts on key priorities and drive desired outcomes. As the saying goes, "what gets measured and rewarded, gets done!" As with all compensation issues, the linkage between CO2 emissions and executive compensation plans should begin with the company's strategy. More and more companies are beginning to incorporate ESG measures within their short- and long-term incentive plans for senior executives, but there is still room for improvement. Analysis of company public disclosures conducted by Willis Towers Watson shows that while approximately 11% of top 350 European companies have CO2 emissions linked to their incentive plans, only 2% of United States S&P 500 companies have it.

If sustainability and environmental goals are front and center of the company's business strategy, then it should consider linking relevant ESG measures to executive incentive plans. There are a few design alternatives to do so, ranging from underpins, to modifiers, to short-term incentive (STI) plans, to key performance indicators (KPIs) within long-term incentive (LTI)plans, and a standalone hyper-long-term incentive plan.

Impact from low (top) to high (bottom)	Pros	Cons
Underpin Include threshold or basic level of CO2 emissions that is required in order for some/all of the payout under other metrics to occur	Appropriate in the case of a company newly introducing CO2 metric	Threshold CO2 performance may not be meaningful or material
Individual performance rating modifier Include a CO2 emissions modifier under the individual elements of the LTI or STI to modify the payout up/down by a certain percentage	Can be tailored to an individual's role and improve line-of-sight	May not promote collaboration by participants to achieve a common material CO2 goal
Plan modifiers Include a CO2 modifier under all (or some) metrics of the LTI or STI to modify the payout up/down by a certain percentage	Standalone metric(s) takes into account the 'how' and the 'what'	Modifier needs to be substantial to have impact, but may not be directly linked to funded results
KPIs in annual bonus Include a CO2 KPI element into the annual bonus scorecard with a higher weight (than current)	Provides a direct measure that reinforces importance of CO2 – easily communicated	Higher weighting of CO2 metric requires clear linkages to funded metrics
KPIs in LTI plans Introduce standalone CO2 metrics within LTI plan	Appropriate for metrics that need longer time horizon to produce measurable results	Depending on length of performance period, may dilute momentum to achieve CO2 results
Standalone incentive plan Introduce a separate incentive plan with the sole purpose of measuring CO2 performance, for example a hyper-long term which aligns with the sustainability strategy	Encourage participants to take a longer-term view of performance	May be difficult to communicate or viewed as duplicative of other incentives

Willis Towers Watson design spectrum

In this context, this article focuses on the last two high-impact ideas for companies to align CO2 emissions with executive incentive plans: (a) incorporating CO2 emission reductions as one of the KPIs in the current long-term incentive plan; and (b) introducing a standalone hyper-long-term incentive plan.

Incorporating CO2 emissions as KPI in performance share plans

Traditionally, long-term incentives have served the purpose of aligning management incentives with long-term shareholder interests. However, as organizations shift focus from shareholder to stakeholder primacy, it behooves them to think of broader KPIs for performance share plans. One such metric could be reduction of CO2 emissions – a standard unit that can be measured and is agreed to by all stakeholders. Most companies should aim for a long-term CO2 emission reduction target and translating that goal into rolling three-year targets – given sufficient weight – will keep management aligned with these goals. Having a standalone CO2 reduction metric allows for higher transparency and better comparison across companies and may overcome dilution of management interest. Overall, incorporating CO2 emission reduction targets in the performance share plans, with at least 20-30% weight, could focus management's efforts to produce measurable results.

Introducing a new hyper-long-term incentive plan

Most CO2 emission reduction targets tend to have longer-term horizons; similar to IPCC's 2030 and 2050 goals. As such, the typical annual and three-year incentives may not be directly aligned with these goals. To encourage longer-term decision making (e.g., a target period of ten years) often associated with large capital investments, and to emphasize its prominence, companies could introduce a separate, hyper-long-term incentive plan focused solely on CO2 emission reductions.

Modern incentive plans are based on time as constant (i.e. one-year or three-year performance periods) and performance as a variable (i.e. achievement of threshold, target, stretch goals). However, a hyper-LTI could allow a different variation, in that the performance goal could be treated as constant (e.g. CO2 emission reduction of 50%), and time could be treated as the variable. Thus, encouraging early achievement of goals via incentive upside, and conversely punishing delayed achievement of CO2 reduction targets with an incentive downside.

Measurement and target setting

The Greenhouse Gas Protocol classifies a company's CO2 emissions under three 'scopes.' Scope 1 is direct emissions from owned and controlled resources, Scope 2 is indirect emissions from sources of purchased electricity and Scope 3 is all indirect emissions along the company's value chain, including suppliers, customers, and partners.

Whilst most companies focus on Scopes 1 and 2, which they can directly influence, progressive companies also focus on Scope 3 and influence supply-chain partners to reduce emissions. Some also track emissions avoided (sometimes informally referred to as Scope 4) due to improvements in efficiency of products and services. Companies also buy Carbon Offsets, which are investments in separate projects (e.g. planting trees), as a way of reducing their net CO2 emissions.

To effect meaningful change, companies should set sufficiently stretched and long-term targets for each Scope as well as at the overall level, which measures reduction both in percentage and absolute (tCO2e; see box below) terms.

What is tCO2e?

- The sixth main greenhouse gases listed in the Kyoto Protocol are carbon dioxide (CO2), methane (CH4), nitrous oxide (N2O), hydrofluorocarbons (HFCs), perfluorocarbons (PFCs) and sulphur hexafluoride (SF6).
- CO2e stands for carbon dioxide equivalents, the standard unit in carbon accounting to quantify GHG emissions, reductions and carbon credits.
- One tonne of CO2 is the unit for GHG emissions, and gases other than CO2 are converted according to their global warming impact and expressed as tonnes of CO2 equivalents, i.e. tCO2e.
- tCO2e is an important agreement in climate change policy as it provides a standard measure of emissions.

Implementation considerations

Implementing such incentive arrangements may not be straightforward. Companies will need to consider whether and how best to rebalance other components of pay, how to deal with disclosures of mega LTI grants and ensuring that targets are sufficiently stretched so that proxy advisors do not perceive these plans to have soft targets as way of boosting executive pay. Large institutional investors have supported proposals for long-term alignment between CO2 emissions and incentives provided that the quantum and opportunity are properly calibrated, and mechanics are carefully laid out.

Call to action

The consequences of climate change have become an ever-more pressing and material issue for society and the business community; companies bear a responsibility to reduce their CO2 emissions. Companies have a pivotal role in slowing down climate change and many existing company targets are clearly not ambitious enough.

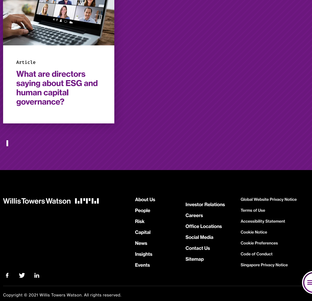
Alignment of executive compensation plans would help focus management's efforts toward these goals. It is paramount, though, to understand the substantial maturity involved when thinking about incorporating CO2 emission reductions in executive compensation. Over time, ESG and environmental focus may become ingrained in management and employees' mindsets, and there may no longer be the need to align incentive plans with CO2 emission reductions.

For now, although not easy, this seems like the right thing to do.

Authors

Shai Ganu
Managing Director and Global Leader, Executive Compensation
Willis Towers Watson
Email | +65 9823 1987

Philipp Geiler
Associate Director, Executive Compensation (Frankfurt)
Email | +49 151 2539 4197



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