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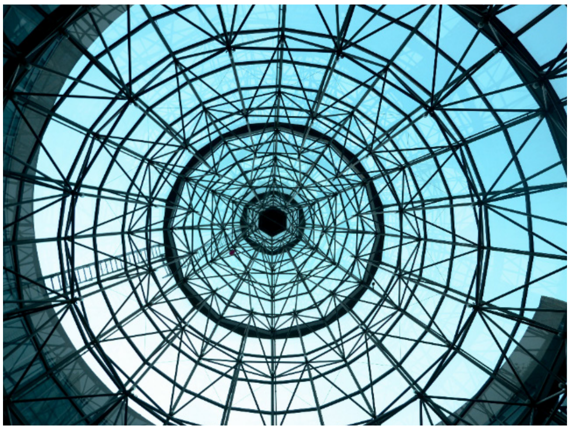


Remuneration Committee update – considering ESG and climate change

We were delighted that over 250 clients and contacts joined us for a recent Deloitte Academy session on how remuneration committees can support wider board action on ESG and climate change.

The world is awakening to the significant environmental and social issues that it faces, and there is growing pressure on governments, businesses and individuals to drive meaningful change. The COVID-19 pandemic has driven a greater appreciation of science to predict future risks, and a change in the US administration is expected to bring renewed momentum in the climate change agenda.

The EU's Sustainable Finance Disclosure Regulation will come into effect with effect from March 2021, redefining ESG disclosures and escalating consideration of ESG in the investment process. Companies with an integrated ESG strategy will be at a competitive advantage in attracting investors, consumers and talent.

Executive pay can play a part in focusing the attention of the board, driving ESG ambitions and delivering a 'tone from the top'. Over 40% of FTSE 100 and 35% of FTSE 250 companies now incorporate ESG metrics under executive incentive plans, and a further shift is expected in 2021 as remuneration committees look to further align strategic priorities with remuneration frameworks. **In this document we explore how to get started, some practical steps and potential pitfalls for remuneration committees in this area.**

ESG and executive pay - an investor perspective...

'Remuneration committees should consider including strategic or non-financial performance criteria in variable remuneration, for example relating to ESG objectives, or to particular operational or strategic objectives. **ESG measures should be material to the business and quantifiable.** In each case, the link to strategy and method of performance measurement should be clearly explained.' **The Investment Association, November 2020**

'LGIM expects ESG to be incorporated into the strategy of the business, the delivery of which should form how the business operates and its purpose. **We therefore believe ESG performance targets lend themselves to act as a modifier to financial outcomes rather than to provide additional reward.** For example, ensuring the health & safety of employees should be embedded in the philosophy and values of the company and a normal expectation of running a successful business. However, for a company that has specific ESG performance objectives that go beyond the company's purpose, or are linked to growth opportunities, e.g. green revenue, we would encourage the setting of specific targets that are linked to this strategy.' **Legal and General Investment Management, November 2020**

Corporate purpose and strategy

Articulating a clear corporate purpose - linking an organisation's intended societal impact to its business model - can provide a 'north star' for boards in aligning financial, strategic and ESG goals. In light of significant COVID-19 disruption for many businesses, institutional investors have intensified their focus on the board's awareness of the risks and opportunities of ESG issues. For companies 'starting out', we are seeing some examples where the development of a clear roadmap for action is included as a specific objective under the personal element of the annual bonus plan.

Identifying your 'material' impact

While boards should take a holistic view of sustainability issues, many companies 'fall over' when focussing on a breadth of ESG areas - it is essential to identify which are the most material. These are likely to be sector specific and where an organisation has the most impact.

Materiality analysis can be carried out to support companies in understanding the risks, opportunities and stakeholder expectations, and define ambitions. Iteration and focus is key in developing clear goals which focus the attention of the board, executive team and employees in their role to deliver them. A key challenge is the inevitable 'butterfly effect' of ESG goals – for example, if we divest from a certain industry or location, what is the social impact? Good practice is still developing and there is no correct answer, but companies should 'be authentic' and recognise complexity in this area.

*'ESG measures should be **material to the business and quantifiable.** In each case, the link to strategy and method of performance measurement should be clearly explained.'*

The Investment Association, November 2020

Executive incentive plans and ESG – which metric?

In the last year we have seen an increased focus on social metrics under incentive plans, and this is expected to continue in areas such as employee wellbeing and COVID safety. In November 2020, the UK government announced a roadmap for Task Force on Climate-related Financial Disclosures to be mandatory for all UK premium listed companies by 2025, and we expect to see increased use of Scope 1, 2 and 3 emissions targets under incentive plans.

Examples of metrics in existing incentive plans

Environmental

CO2 emissions – scope 1, 2 & 3
Carbon intensity
Water efficiency
Vehicle fuel efficiency
'Green' financing
Plastic use
Recycling rate
Flight emissions
Hazardous waste
Renewable energy consumption
CDP rating

- ✓ Emerging as the primary focus of investor groups (e.g. ShareAction)
- ✓ More common in LTIP
- ✓ Often stand-alone metrics
- ✓ Potential use of reporting standards (e.g. TCFD)

Social

Digital education
Women in leadership
Community outreach
Fair tax policy
Accident / incident rate
Real living wage
Digital connections
Responsible supplier policy
Responsible gambling
Ethnic diversity
Employment for under-represented groups

- ✓ Increasing focus post COVID-19
- ✓ Emergence in annual bonus and LTIP scorecards
- ✓ Internal and external metrics? E.g. D&I versus societal / community programmes

Governance

Cyber/ data security
Regulatory relationships
Risk management strategy
Culture and engagement
Conduct and complaints
Internal controls
Financial crime
Crisis management
Risk and ethics training

- ✓ Commonly part of FS scorecard in annual bonus
- ✓ Focus on risk frameworks, health and safety – part of 'day job'?

Design approaches

ESG metrics are currently more common in the annual bonus plan than LTIP. According to a recent Deloitte poll, around 35% of companies expect to incorporate an ESG metric under the annual bonus plan in 2021, and around 25% plan to introduce an ESG metric under the LTIP.

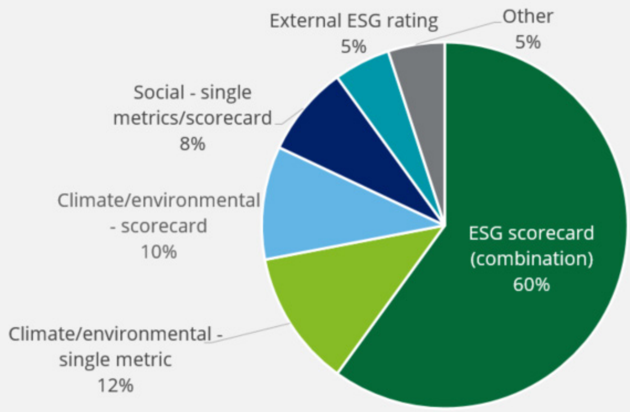
The most common design approach is the use of a scorecard or stand-alone metric, typically with a small weighting of 10-20% of maximum opportunity. In some cases, remuneration committees plan to increase the weighting over time as they 'test run' performance measurement in this area.   A range of design approaches can be adopted, from the use of an underpin hurdle to a stand-alone incentive plan.

Underpin	'Modifier'	Basket or scorecard	Stand-alone metric	Stand-alone incentive plan?
Inclusion of ESG-related underpin before some or all element can pay out	*ESG modifier applied to incentive out-turn e.g. +/- 10%*	*e.g. 4-5 ESG-related KPIs assessed as part of scorecard*	*Single 'material' KPI linked to stand-alone incentive element (typically 10-20% weighting)*	*Separate incentive plan linked to ESG goals and aligned to specific timeframe*

A recent Deloitte poll showed that around 60% of companies using or planning to use an ESG metric under executive incentive plans will adopt a 'scorecard' of metrics. When using this approach, it is important to ensure that metrics havie a meaningful weighting. For example, will a weighting of 2% of the overall bonus opportunity be impactful in terms of driving performance? As companies become more familiar with measuring and monitoring performance, we expect standalone metrics to be more common place, and most effective in driving improvements.

According to a recent Deloitte poll, around 35% of companies expect to incorporate an ESG metric under the annual bonus plan in 2021. Around one-quarter plan to introduce an ESG metric under the LTIP.

ESG metrics and incentive plans - what approach are you using / most likely to use? *(Deloitte Academy poll results, February 2021)*

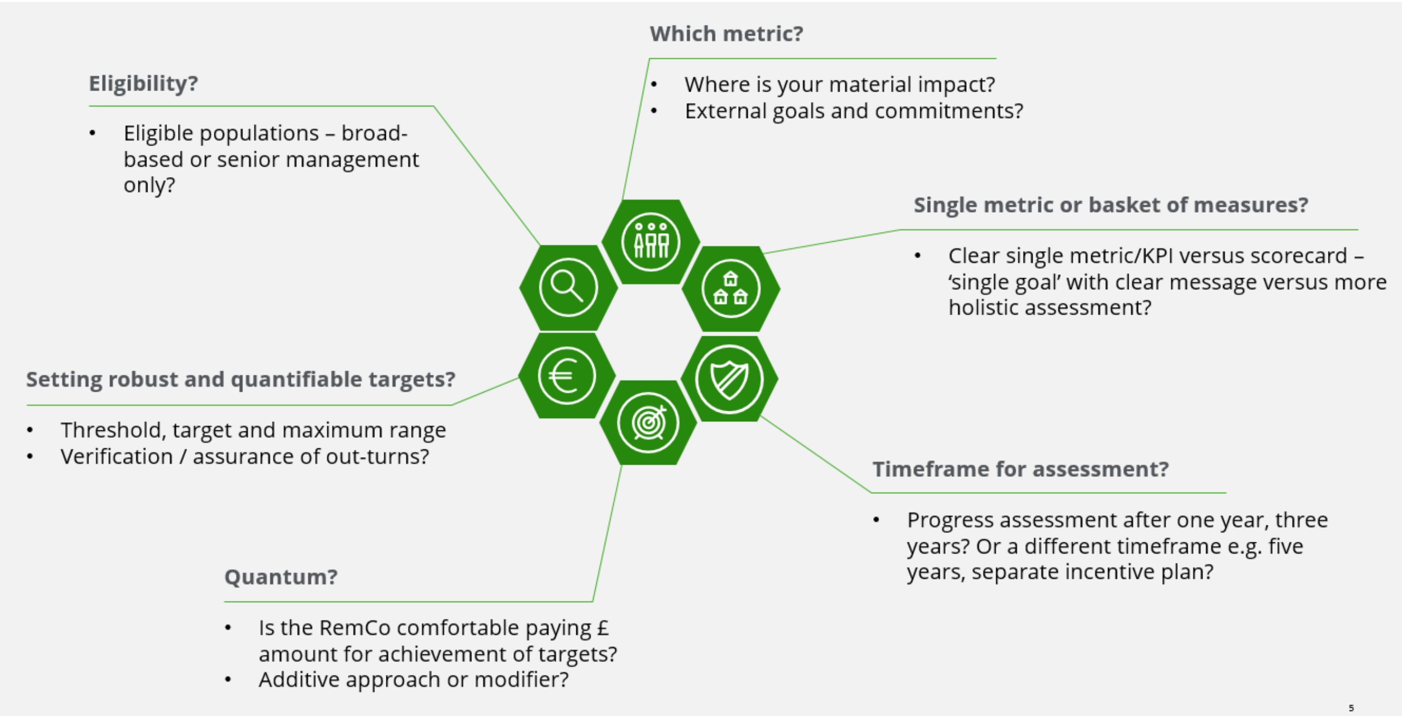


Measurement and verification

While the assessment and verification of financial results is well-established, the process around ESG metrics is evolving. The use of established sustainability reporting frameworks (e.g. Global Reporting Initiative, Sustainability Accounting Standards Board) can be helpful and enable metrics to be tied back to reported figures in the annual report.

A key challenge to date has been access to high quality data, and remuneration committees, HR and sustainability experts should work together to 'get under the bonnet' of the ESG metrics used and ask challenging questions. For example, if measuring Scope 1 and 2 emissions, does robust data exist for all regions in which the company operates? While external assurance can be sought to verify incentive outcomes, this may be an area where judgement and discretion are needed to fairly assess progress against objectives set.

Key questions for remuneration committees



Communications and reporting

Clear communication of sustainability goals and how these are aligned to the reward framework can focus the executive team and demonstrate commitment to your ESG strategy and performance plan.

From an external perspective, a number of proxy agencies and investors have recently included updates on the use of ESG metrics in their guidance on executive remuneration. While generally supportive, investors expect full and detailed disclosure around the targets set and achievements made, and will closely scrutinise incentive out-turns. Remuneration committees should be open and transparent in communicating how they plans to assess performance and progress, including where expected judgement and discretion may be required.

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