Compensation Committees & ESG

Human capital management and oversight should be a bigger part of the agenda.

By Don Delves and Ryan Resch

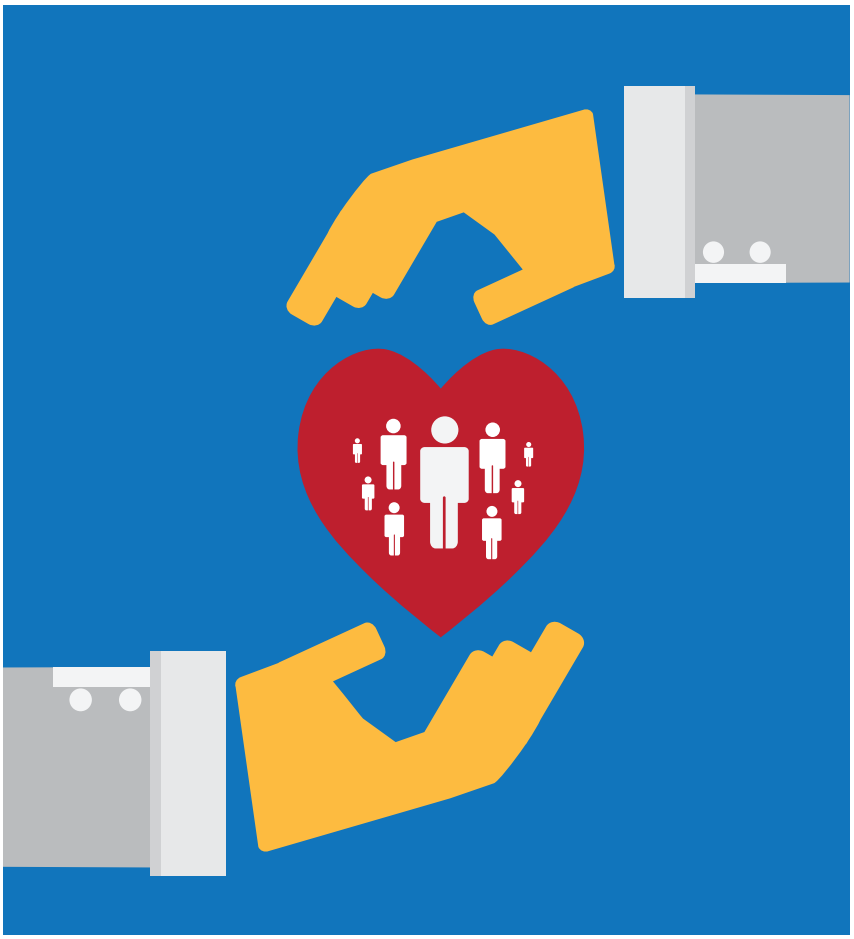
Environmental, social and governance (ESG) issues are increasingly important to boards and their compensation committees, especially human capital management, as a critical part of the "S" in ESG.

Comp committees realize it directly relates to their mission, long-term strategy and success, and they're being more proactive.

Here are three recent examples. We chose to not identify two of the companies.

• At Royal Dutch Shell plc., the company committed to use ESG as an executive compensation performance measure in an effort to reduce its net carbon footprint 20% by 2035 and 50% by 2050. Executives' pay will be linked, in part, to this target, through an energy transition measure within their 2019 long-term incentive award.

• Board members of a power generation company asked for more insights after a social responsibility report found a gender pay gap existed based on the ratio of average female pay to average male pay. The analysis examined demographics by level, pay gaps by level and job family, and promotion and pay increase trends by gender. Findings reinforced that the company was paying men and women in jobs of equal value at similar levels. However, the check also uncovered that more men worked at higher levels of the organization, and an inclusion and diversity strategy was needed to encourage a



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• An integrated oil and gas company wanted better insights on key human capital metrics in support of the organization's people strategy so management proposed a series of measures in a dashboard that could be updated quarterly for review at each committee meeting (e.g., demographics, promotion/turnover rates, talent pipeline, wellness, safety and productivity/returns. The dashboard for the compensation committee provides greater context for each performance measure (i.e., historical trends and/or relative benchmarking against other organizations) and includes a mixture of leading and lagging indicators.

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External drivers only partly explain ESG's growing prominence among comp committees' priorities. There's also a recognition among these directors that addressing broader human capital management issues are important for sound reasons.

Legal: Organizations attuned to human capital management tend to treat risk management more holistically, and work to minimize the risk of legal action based on unfair treatment or discrimination towards employees. The need to worry about this particular unsystematic risk is reduced, freeing boards and managements to turn their attention to intelligent risks that are connected to both financial performance and strategic goals.

Reputational risk: Inattention to ESG in general, and human capital management in particular, can damage an otherwise well-conceived and -developed brand, resulting in lawsuits and negative press attention. Even more insidiously, it can subtly undermine talent acquisition and retention, as candidates with desired skills are drawn to employers with more attractive hiring practices, employee guidelines and culture.

Talent: Diverse, empowered workforces that are treated and paid fairly may perform better, a key determinant in the creation of sustainable, long-term value. As an example, a large Midwest tech company cites programs toward this end that include training to avoid unconscious bias in hiring and leadership development and actively pursues a more inclusive, diverse culture at all levels. The result is a greatly enhanced ability to develop and deliver new products to new customers through new channels.

A good start, but more needs to be done

Organizations are taking human capital management seriously, but fully integrat-

ing it into the compensation agenda will require more action.

Committees will want to consider changing their charters to reflect their broader mission. They should actively recruit members with diverse backgrounds and viewpoints. We believe that they will start to manage human capital in the organization similarly to how financial capital is managed, with a greater focus on improving return on investment, including:

• Managing both the costs and productivity of human capital investments.

• Effectively cascading performance goals throughout the organization.

• Understanding and targeting roles that disproportionally create value.

Human capital oversight will also need to consider dynamics that impact long-term sustainability: I&D, gender and fair pay, human capital-related risk, culture and its alignment with strategy and risk, and the changing nature of work.

The culture of both the organization and the board needs to be defined, assessed and monitored. How does culture impact key issues such as cybersecurity, reputation and safety, and is culture properly reflected and reinforced by compensation policies?

Recommendations for change

Companies face both top-down scrutiny by investors and bottom-up pressures from their work forces, and their compensation committees are pivotal to satisfying both these constituencies. It's imperative that management and boards assess whether their compensation committees are advancing human capital management and consider.

Roles and responsibilities: Compensation committees should analyze whether their role should be expanded, and what new decision-making authority, tools and data are needed to meet this expanded remit.

Information requirements: High-quality human capital management dashboards can help boards and compensation committees understand an organization's progress and provide data-driven, analytical information. This may also require independent advice to ensure that the right type of information is provided and monitored.

Process: Generic charters referencing HR philosophy or oversight need to become more specific. Changes such as revised decision rights, new reports, data and discussions with management need to be proposed to the full board and built into the compensation committee calendar so that oversight becomes a regular, institutionalized part of the board's responsibilities.

Reporting: Accountability and how an expanded role will affect what is reported to the full board, employees, shareholders and the public need to be discussed.

These important steps will help compensation committees evolve and oversee employee engagement, talent management and development processes that support greater diversity, deeper bench strength and tighter alignment with their total rewards programs. They will help contribute to a sustainable, long-term growth demanded by institutional investors. ■

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