ESG and Executive Compensation:

Hearing from board members globally

Introduction

Environmental, social and governance (ESG) issues are emerging as top priorities in the boardroom. To supplement existing academic and business research in this area, we seek to provide a unique perspective by directly projecting the voices of board members around the world.

Three primary sources of information represented in this research report

170

Board member interviews

- Interviews were conducted with 170 board members in 20+ countries, across all continents except Antarctica
- Anonymous director quotes are referenced throughout this report

168

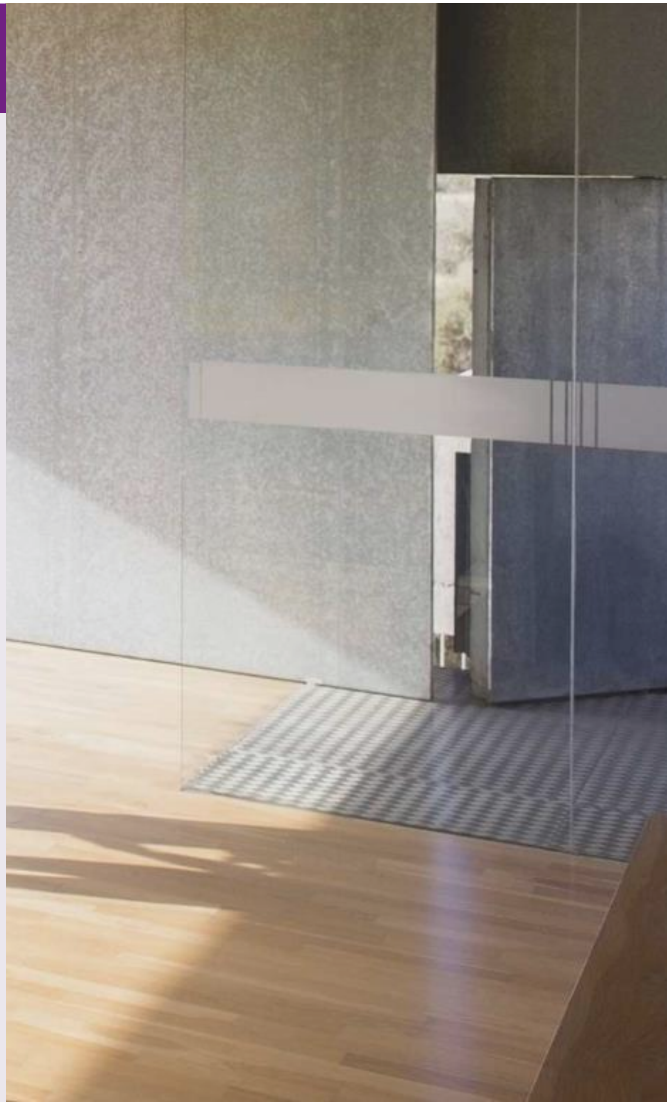
Board member survey

- Survey responses were received from 168 board members and senior executives globally

2,000+

Public disclosures

- Our Global Executive Compensation Analysis Team (GECAT) reviewed ESG-related public disclosures from 2,000+ companies:
  - S&P 500 / TSX 60
  - Over 350 of the top companies in Europe (constituents of 11 major European stock exchanges, including FTSE 100)



Executive summary

While practices and philosophies vary by geography, industry and organization type, we have observed some universal themes:

Board members generally see a well-articulated purpose as a competitive advantage and that considering for all stakeholders' interests (e.g., employees, suppliers, customers) creates sustainable long-term value for shareholders.

Current events shape ESG priorities. In 2020, social issues have gained momentum.

Looking ahead into 2021, Climate and climate transition priorities is becoming an increasingly important focal area for Boards.

Most of the largest companies in North America and Europe already incorporate ESG metrics into executive pay plans.

Human capital is seen as a critical business asset, and boards expect to play an oversight role on issues such as culture; succession planning; and diversity, equity and inclusion (DEI).

4 in 5 companies are planning to change ESG measures in executive pay plans over the next 3 years

Purpose, profits and shareholder primacy

In our research, board members shared with us their agreement on the need to clearly define company purpose, which differentiates a corporation from its competitors, and the competitive advantage in turn helps create tangible value.

A well-articulated organizational purpose also has the power to rally employees, and a company’s social and environmental contributions can help create a compelling employee value proposition.

We also tested the debate regarding shareholder vs. stakeholder primacy. Most directors felt that the company should have a commitment to all corporate stakeholders, including customers, employees, suppliers, environment, community and shareholders

> “Measuring company decisions against purpose provides a social license to operate and leads to better returns for shareholders because the company is seen as a force for good.

> “Major employers are investing in their workers and communities because they know it is the only way to be successful over the long term.

Maximizing long-term shareholder value

Board members we spoke with acknowledge their fiduciary responsibility to act in the best interests of the corporation, which generally means acting in the interests of shareholders.

However, there is also agreement that other stakeholders cannot be ignored in the pursuit of maximizing long-term shareholder value. These stakeholders include customers, suppliers, employees, vendors and the community.

Optimizing the balance between short- and long-term value creation is a constant challenge for corporations. Board members agree that ignoring other stakeholders can increase risk, threaten business sustainability and be detrimental to shareholders.

> “It’s great to be worthy, but not at the expense of shareholders. In a sense, shareholders want us to focus on doing the right thing but not as a trade-off on results. They want ‘and’ instead of ‘or.’

> “At the end of the day, our company is part of this community. We helped build it and we love it. It is in our best interest for the community to like us. Otherwise, they are going to kick us out.

> “The conflict is not shareholders versus stakeholders but short- versus long-term profits.

ESG in the boardroom

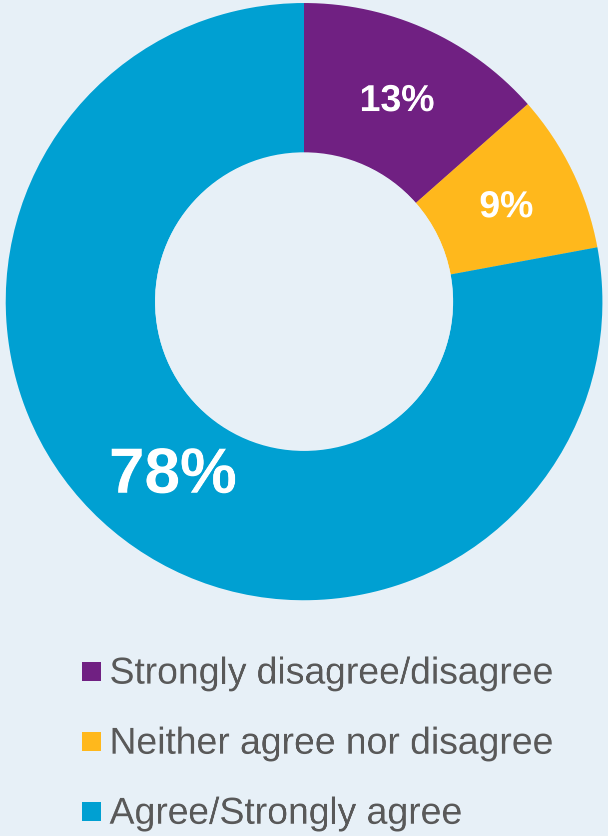
Board members recognize the symbiotic relationship companies have with their communities, that, in the long run, investments in local communities create a sense of pride among employees. This in turn fortifies a strong culture.

The investment community has a significant impact on boardroom discussions. The growing momentum of ESG (or sustainable) investing is making its way into boardrooms.

In Europe, the evolving regulatory environment also continues to push ESG issues such as greenhouse gas emission, gender pay gap disclosures and data privacy on to board agendas. Regulatory pressure also gives the investment community a greater push for ESG actions.

Perhaps most important, board members see ESG issues as a business risk. Consumer behaviors are increasingly influenced by how companies respond to key ESG issues such as climate change and diversity, equity and inclusion. Talent seeks to make environmental and social impact at their work. There is ample evidence suggesting that companies with a strong ESG profile outperform their competitors.

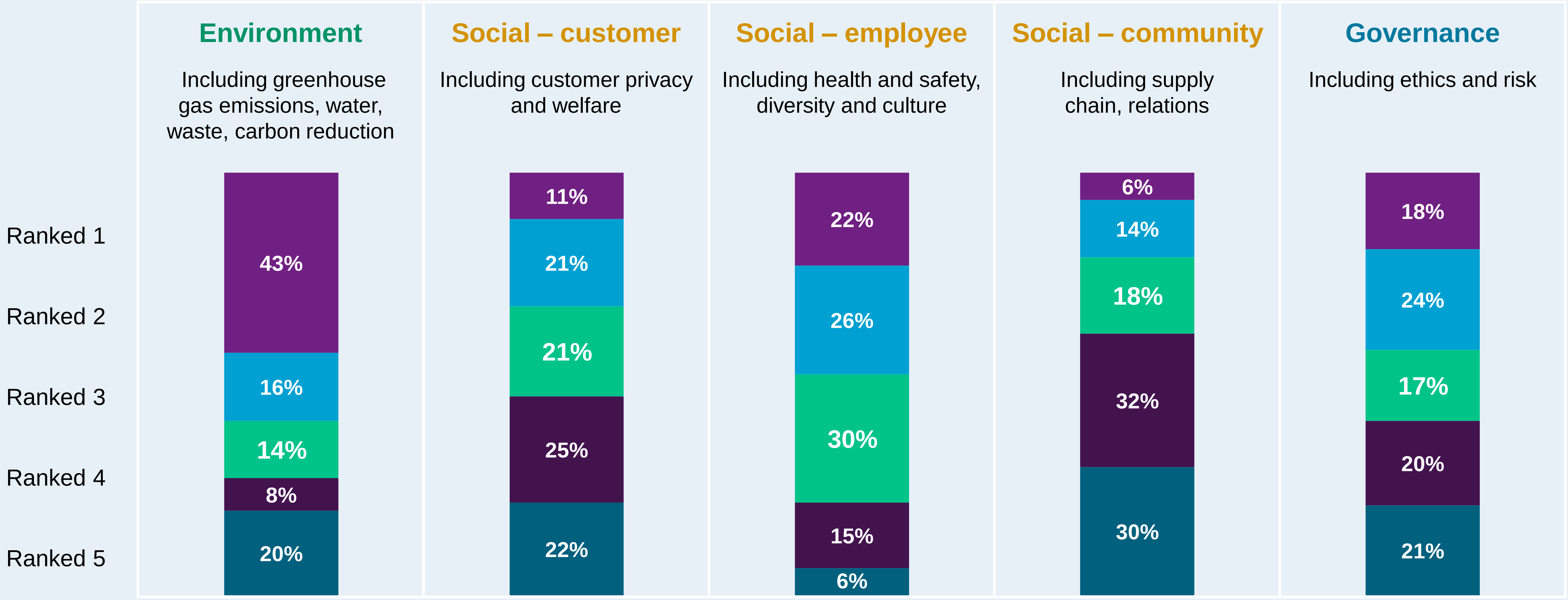
To what extent do you agree that strong ESG performance is a key contributor to creating organizational value/stronger financial performance?



Source: 2020 ESG Survey of Board Members and Senior Executives

Board's ESG focus

What is the relative importance of the following ESG priority areas for your organization in the next three years (rank in order of importance from 1 to 5)?



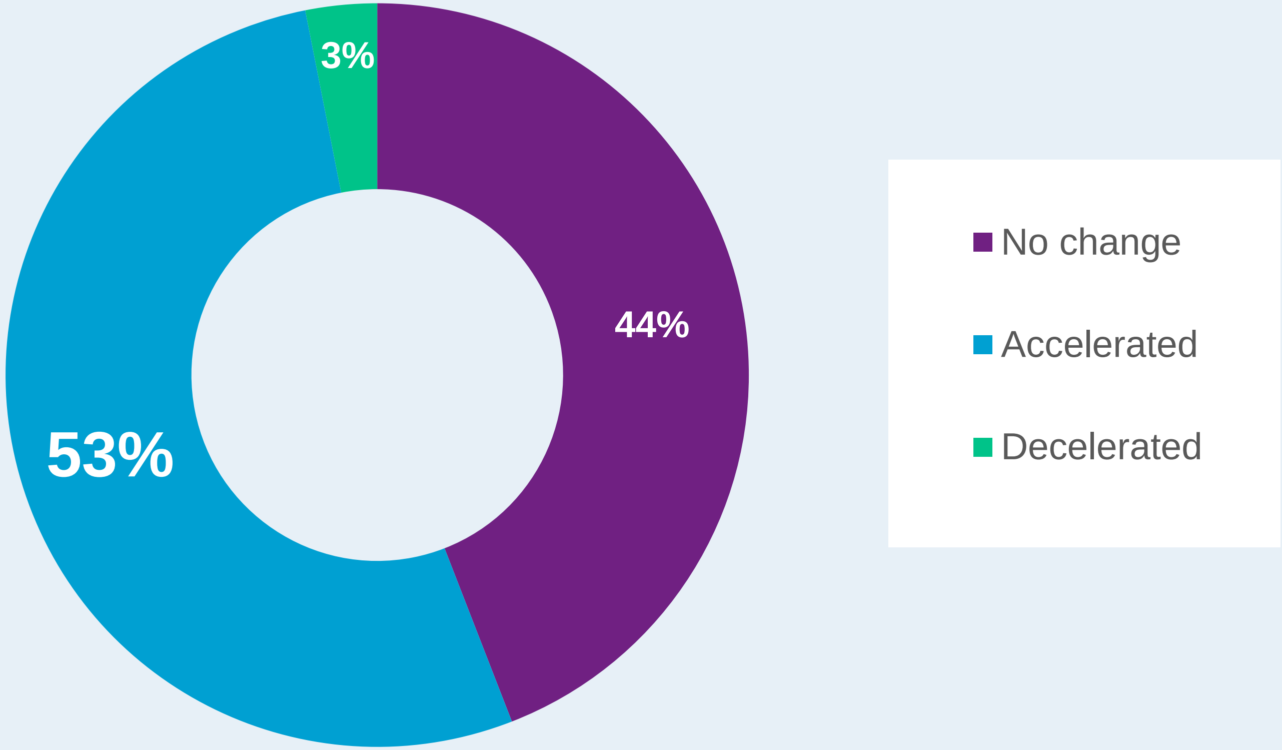
Boardroom discussions about ESG have been evolving. In many industries, certain ESG metrics (e.g., employee safety and pollution standards) have been core to measuring company and executive performance.

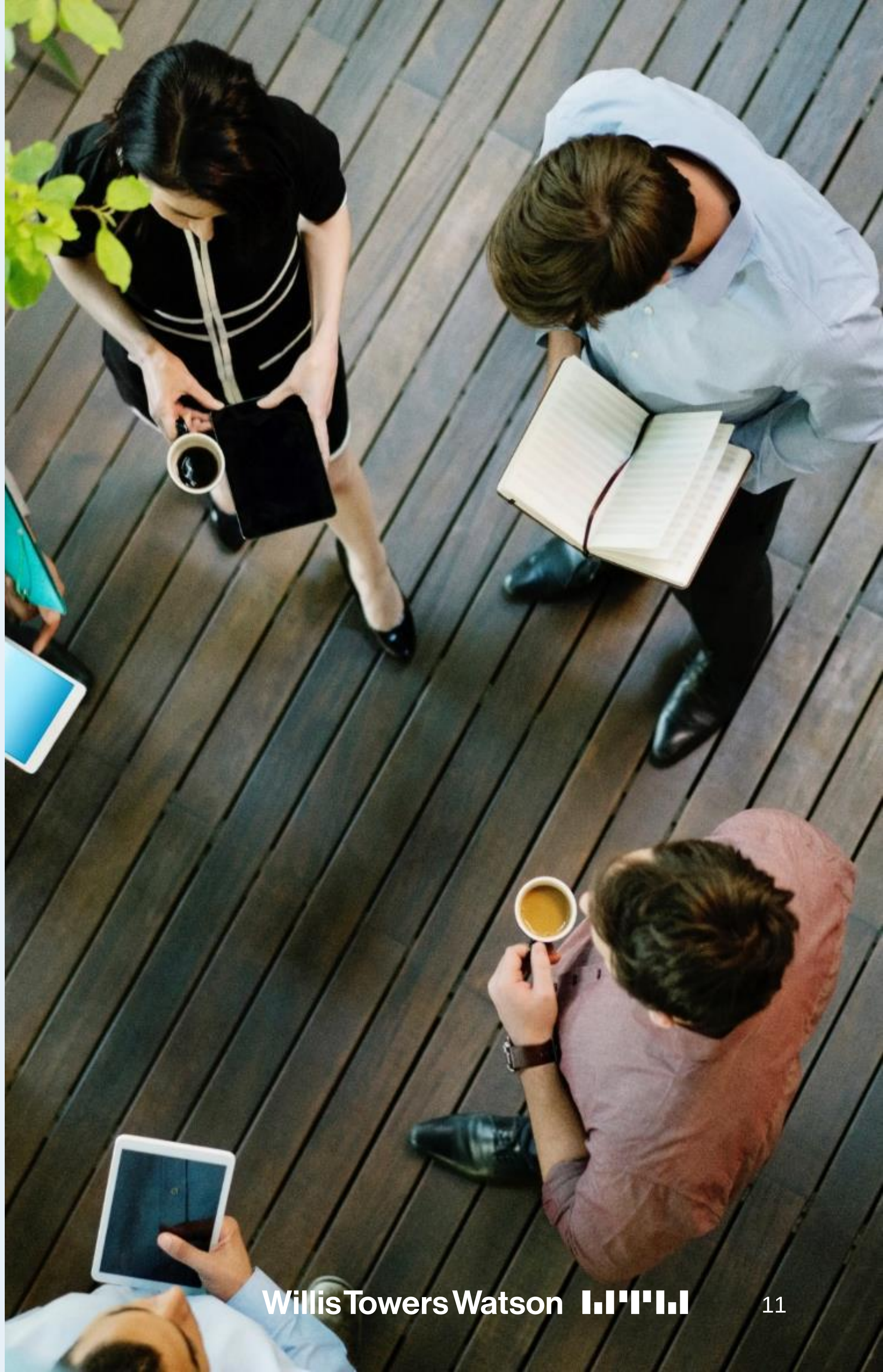
Social issues gained significant momentum in 2020, prompted by a combination of the global COVID-19 pandemic, the resulting economic recession, and social and racial justice movements in some countries. A majority of board members we surveyed believe that these factors have accelerated ESG priorities at their organizations.

Looking ahead to 2021, we expect organizations to focus on climate change and transition as a top business risk. Numerous influential investors have connected climate risks with investment risks, calling for boards to challenge management in assessing the company’s risk exposure to climate change and transforming the business model to be compatible with a net zero economy.

ESG in the boardroom

Have current events (e.g., pandemic, recession, social and racial justice, income inequality) changed your ESG priorities and/or timing?





How are boardroom discussions on ESG taking shape?

The topic of ESG is complex and quickly evolving, particularly in the context of a business. Boardroom diversity enriches discussions in the boardroom and fosters an environment in which conventional views may be challenged.

An overwhelming majority of directors believe that a company's ESG priorities and agenda should be a strategic discussion with the full board (or supervisory board, in two-tier board structures).

Depending on the board structure, some oversight responsibilities may be delegated to committees.

The board's role should be to advise and govern, and the ESG agenda should ultimately be driven by management (ideally spearheaded by the CEO).

A clear construct on ESG accountabilities across board committees (as well as the full board) can help drive the necessary change. Lack of clarity regarding accountability and responsibility often leads to inertia, which some board members find frustrating.

ESG development is often highly contextualized within each market, based on how certain environmental and social issues are framed.

How are boardroom discussions on ESG taking shape?

“ESG is like an elephant because there are so many components. Some people are describing the trunk and some the tail. Some want to talk about climate change and others want to talk about pay equity. Directors come from different backgrounds and are passionate about different things.

“What has changed for us is that our investors have become more up-front about what they want. The challenge is that sometimes investors tell us to focus on different things.

“Degree of board alignment is all over the map. That’s OK as you need a healthy level of debate and diversity of opinions. In general, skepticism on ESG is waning.

Willis Towers Watson

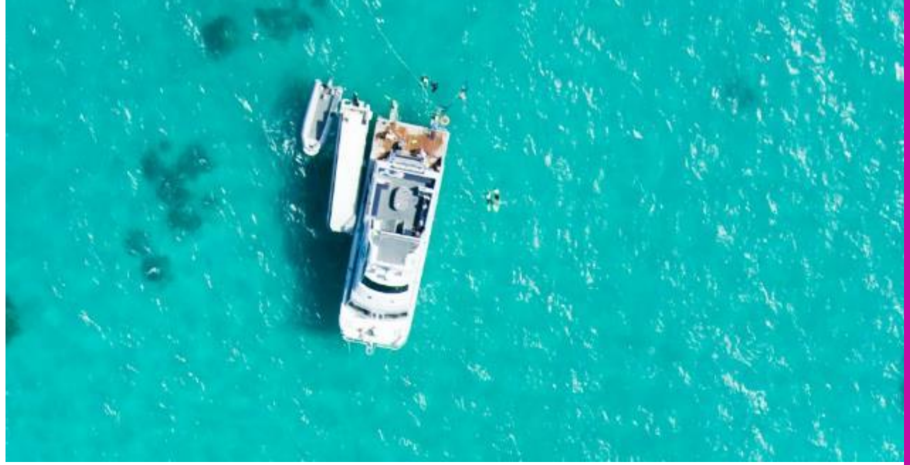
Connecting ESG and executive compensation

A majority of board members we spoke with believe that executive incentive plans should include some ESG metrics. This was especially true of those who sit on boards of public companies in North America, Western Europe and other countries with mature corporate governance constructs, such as Singapore.

Selecting the right ESG metrics is no easy task. Most board members find it challenging to narrow down the discussion on suitable ESG metrics out of hundreds of options. The consensus is not to consider this a "check the box" exercise but to identify metrics that are linked to the company's purpose and ones that truly drive long-term, sustainable value creation for the company.

Many board members consider standardization and comparability to be key criteria for good ESG metrics. That said, there is acknowledgement that most metrics are internally focused specific to each company's priorities and situation.

Among those who do not agree with linking ESG and executive compensation, the belief is that driving the ESG agenda should be a core part of their organizational culture. Measuring key performance indicators (KPIs) related to ESG does not have to affect executive pay outcomes.



> "
> Incentive is a powerful tool.
> If you want people to act a certain way, reward them for it.

> "
> The last thing we want to be accused of is 'greenwashing.' We care because we know our customers care. Adding a metric is a way to show that you 'walk the talk.

Connecting ESG and executive compensation

What challenges have you experienced when considering the incorporation of ESG metrics into your executive incentive plans?

Source: 2020 ESG Survey of Board Members and Senior Executives

Prevalence of ESG metrics

Use of ESG metrics in executive incentive plans is prevalent in North America and Europe, especially in annual incentive plans.

The tendency to measure ESG in terms of annual progress rather than long-term achievement is mostly attributable to the challenges in setting long-term goals. Annual ESG goals should be tied to a long-term vision and a clear ESG agenda.

Like any executive incentive metric, board members generally prefer ESG metrics that are quantifiable and measurable. Some prefer a simple set of KPIs measured with a scorecard approach.

Use of ESG metrics in Europe

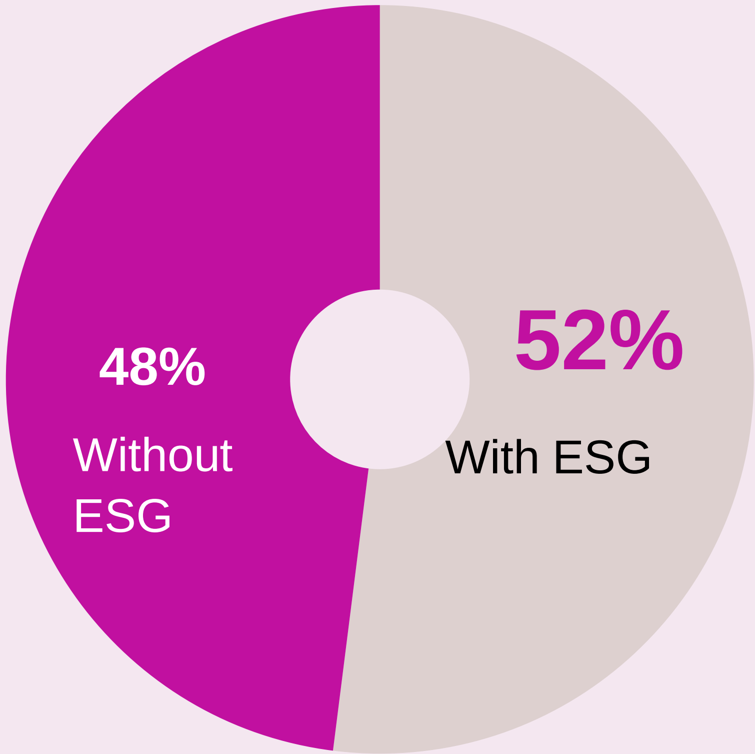
Use of ESG metrics in executive incentive plans is more prevalent in Europe – used by 63% of constituents of major indices.

ESG metrics are more commonly found in long-term incentive plans for European companies (15% prevalence) versus S&P 500 companies (3% prevalence).

Notes: Data based on Willis Towers Watson's proprietary research using public disclosures. Europe results were as of June 2020. Major indices included in this research included BEL 20, OMX Copenhagen 25, CAC 40, DAX 30, FTSE 100, ISEQ 20, MIB 40, AEX 25, IBEX 35, OMX Stockholm 30 and SMI 20.

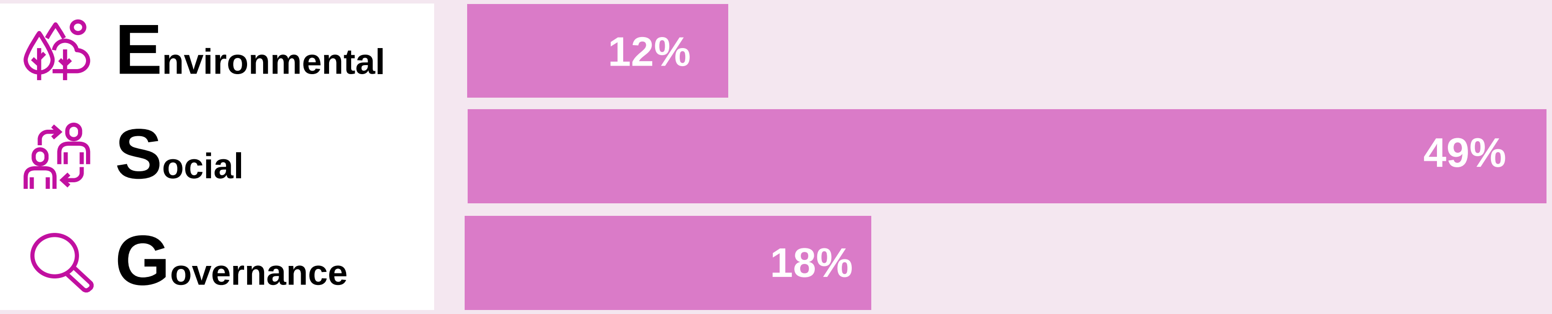
Prevalence of ESG metrics

S&P 500 companies



51% Annual incentive incentives

3% Long-term incentives



Use of ESG metrics in Canada

Use of ESG metrics in executive incentive plans is more prevalent in Canada – used by 68% of TSX 60. Like Europe and the U.S., most ESG metrics are used in annual incentive plans. Only 2% of companies include ESG metrics in long-term incentive plans.

Notes: Data based on Willis Towers Watson's proprietary research using public disclosures. S&P 500 results were as of November 2020. TSX 60 results as of May 2020.

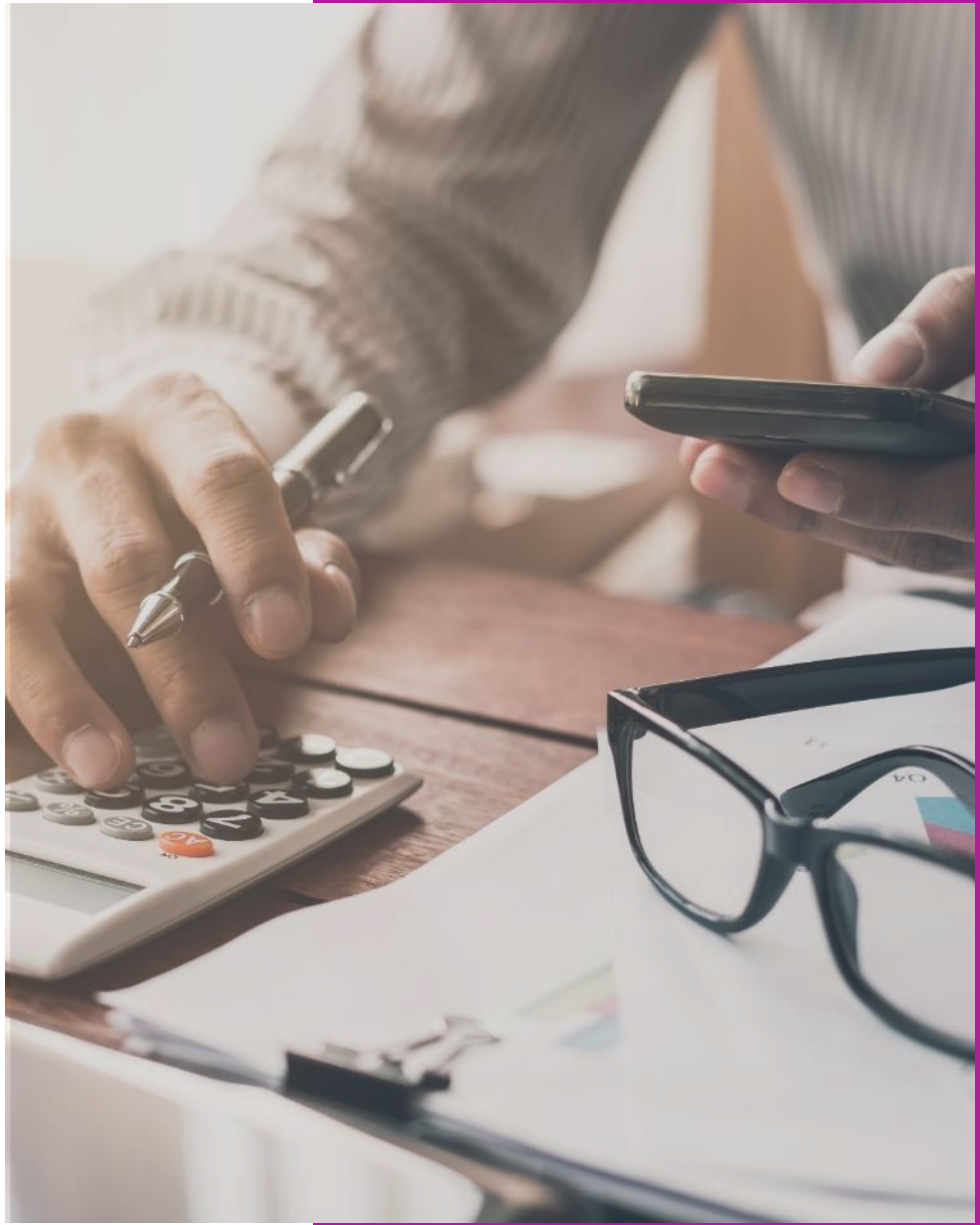
Getting ESG metrics right

The emphasis on social ESG metrics is common between North America and Europe. Among the companies that use ESG metrics in executive incentive plans, most have one or more focused on employees.

Specifically, the most prevalent category for both regions is people and HR, which includes metrics such as succession planning, talent development, employee engagement and culture.

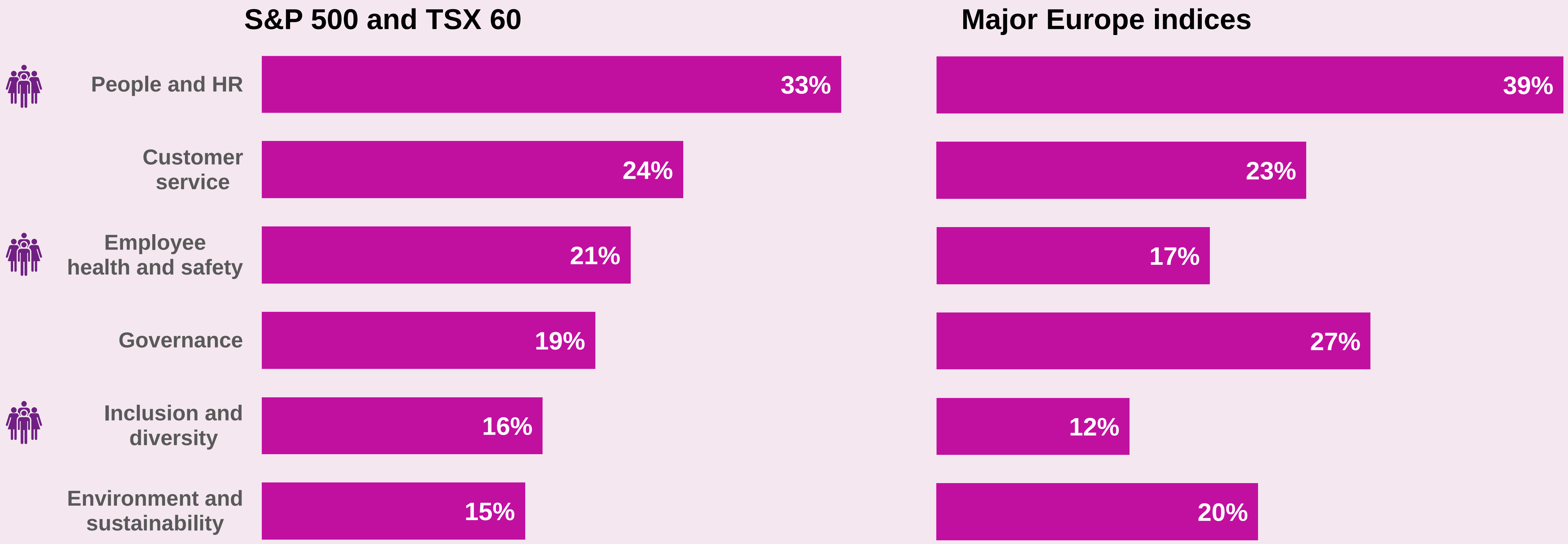
There are more noticeable differences in the usage of environmental and governance metrics. Relative to the S&P 500, European companies are more likely to use executive incentive metrics in the environment and sustainability and governance categories.

Incorporating ESG metrics into executive incentive plans is more common in the energy and utilities industries, where there is a long-standing history of minimizing environmental damage and protecting employees' safety.



Getting ESG metrics right

People-related



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Setting a long-term plan

Despite goal-setting challenges, board members expect increasing incorporation of ESG measures into long-term incentive plans in the next three years. ESG will be measured with a balance between annual progress and long-term achievements.

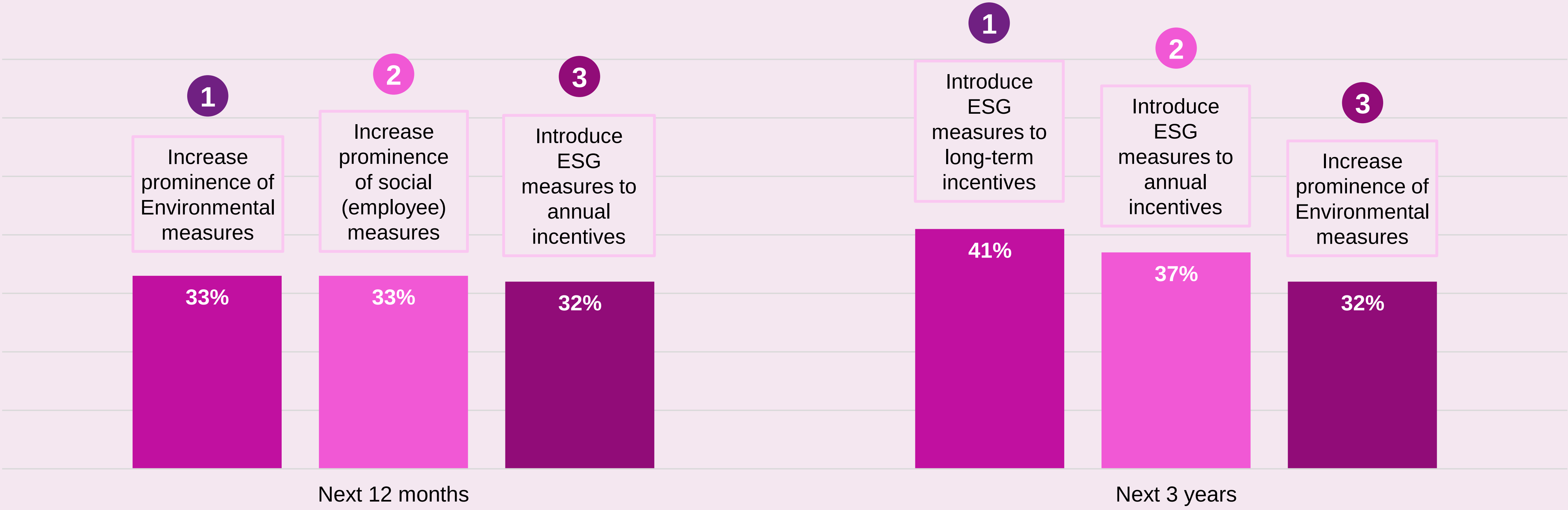
Some ESG objectives may take a long time to realize, such as a shift to net zero. The time horizon far exceeds the typical length of long-term incentive plans, leading to discussions about hyper long-term incentives. This could be either a plan with a very long performance measurement period (e.g., five to 10 years) or a plan with a set long-term goal that pays sooner to reward achievement ahead of schedule.

Hyper long-term incentive (a plan where the long-term goal is a constant, such as carbon reduction, and the amount is earned as soon as achieved) a may be a creative solution but does not appear to have gained traction in the market.

Across measurement categories, the two that have drawn the most attention from board members are environmental and employee-related (social) measures. Organizations not considering any ESG measures in the next three years are in the minority.

Setting a long-term plan

What are the top three ESG changes to your executive incentive plans are you planning over the next one to three years?



Source: 2020 ESG Survey of Board Members and Senior Executives

Human capital governance

Increasingly and across all geographies, board members see human capital as being fundamental to business health and performance. It is a key issue for the board; hence, many directors we spoke with believe that boards should play an oversight or stewardship role in HCG.

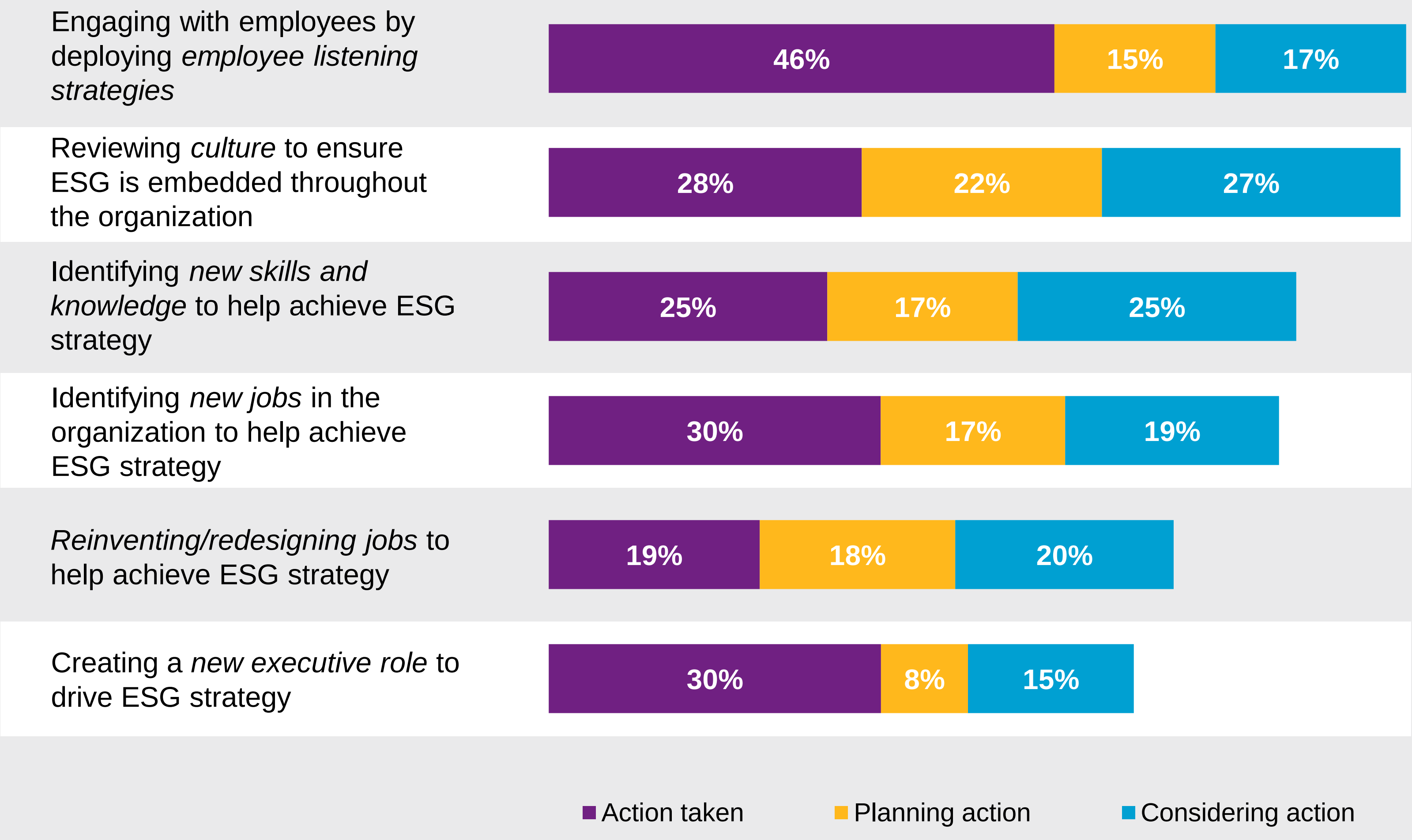
In addition to remuneration offerings, employees today are much more mindful of an organization’s purpose, particularly the younger generations. This has prompted organizations to invest more heavily in an employee value proposition that highlights commitment to diversity, equity and inclusion and to climate transition.

In the context of HCG, board members see their role as providing oversight. They are inclined to raise questions and expect management to execute due diligence, to provide data and to respond accordingly.

Many board members shared with us that their organizations have begun to review their workforce through an ESG lens. They see these actions as a way to gauge management’s commitment to executing the organization’s ESG strategy.

> “There are times when the most critical people are not in the committee’s purview. One of the things we’ve done is try to identify the high-impact people; we need to know who they are.

To what extent have you started to review your workforce through an ESG lens?



Oversight and stewardship

When it comes to defining the board's oversight or stewardship role in HCG matters, board members see this as a shared responsibility between the full board and designated committees.

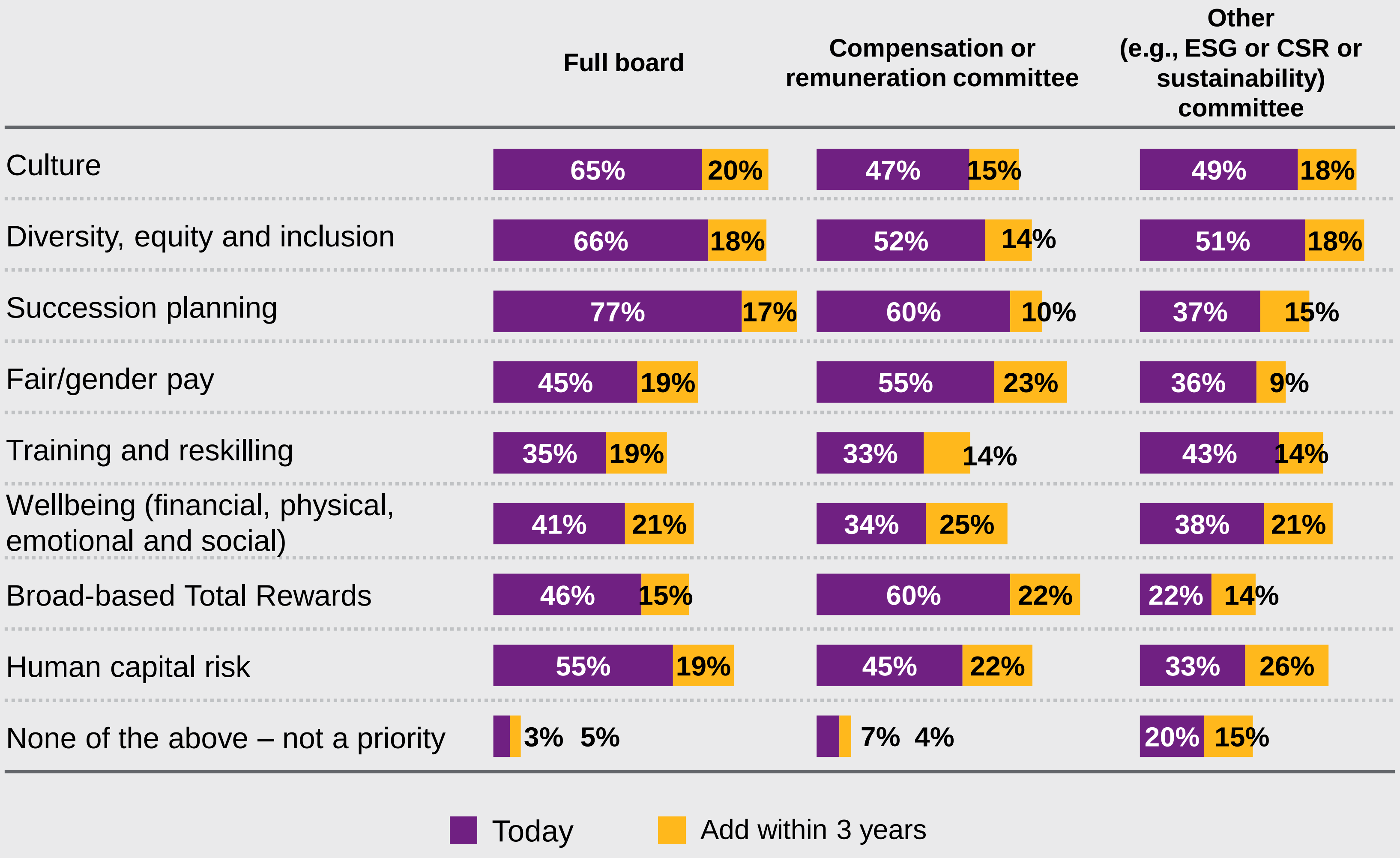
Compensation committees of the largest companies in the world have expanded their remit: One-third of S&P 100 companies now include culture, as well as employee relations and engagement, in their committee's charter.

Similar trends have been observed around the world, in remuneration committees in the U.K., HR committees in Canada, executive resources and compensation committees in Singapore, and combined nomination and remuneration committees in Japan.

Which of the following topics does your board (or a specific committee) oversee? Which do you anticipate your board (or specific committee) overseeing within the next 3 years?

Succession planning, diversity, equity and inclusion and culture are the three human capital topics that most often get the full board's attention.

Compensation issues such as pay equity and total rewards for broad-based employees typically fall under the compensation (or remuneration) committee's remit.



Shaping culture

Boards have a role to play as the custodian of company culture, and external pressure is a significant contributing factor. Boards recognize how cultural issues can corrode workforce behaviors, which can result in damage to a company's reputation and its shareholder value.

While boards fully expect management to shape the culture and drive change, they feel responsible for ensuring that management is shaping a culture that drives value for the company in the short-, medium- and long-term and that is aligned with the company's purpose.

For example, the board can drive cultural change by appointing a CEO who shares the same values as the board and by considering cultural alignment as one of the criteria for success planning discussions.

Beyond management reporting issues such as cultural dashboards, some board members we spoke with underscored the importance of listening to people directly when trying to understand organizational culture.

> "Human capital management can be a virtuous circle; when done right, it can have a long-lasting positive impact on an organization's culture and financial results.

> "Board's role in shaping culture is absolutely critical, in the sense that we need to choose a CEO who shares the vision of culture we want the company to have.

Focus on environment and climate

Climate change creates risks and opportunities for corporations. In many parts of the world, transitioning to a low-carbon or net zero business has been a top organizational priority. Board members expect management to articulate the business's risk exposure to climate change as well as the strategy to mitigate such exposure.

In the United States, where the focus on climate change has been slightly behind other markets, board members expect climate transition to be under the spotlight in 2021 and beyond. A constant push from the investment community is a huge driver. Leading investors equate climate risks and investment risks.

In fact, board members rank environmental and climate issues as their number one ESG priority for the next three years. This is particularly true in industries (e.g., mining, oil and gas, chemical manufacturing, transportation and energy) where environmental matters have long been a risk-management focus.

Increased prominence of climate metrics

Sectors with a high impact on the environment lead the way in Environmental metrics: Energy, utilities, materials. These sectors also focus on climate transition KPIs. Among companies that use Environmental metrics, it typically makes up 10-15% of total CEO compensation.

In Europe, Environmental metrics are the most common ESG metric in the LTI.

ESG metrics are more common in annual, not long-term incentives. However, in Spain, France, Netherlands, more than 20% of companies have ESG in their LTI plans.

11% of European companies, but only 2% of US S&P 500 companies, have CO_2 emissions linked to their incentive plans.

Looking ahead: Top ESG focus by region

North America

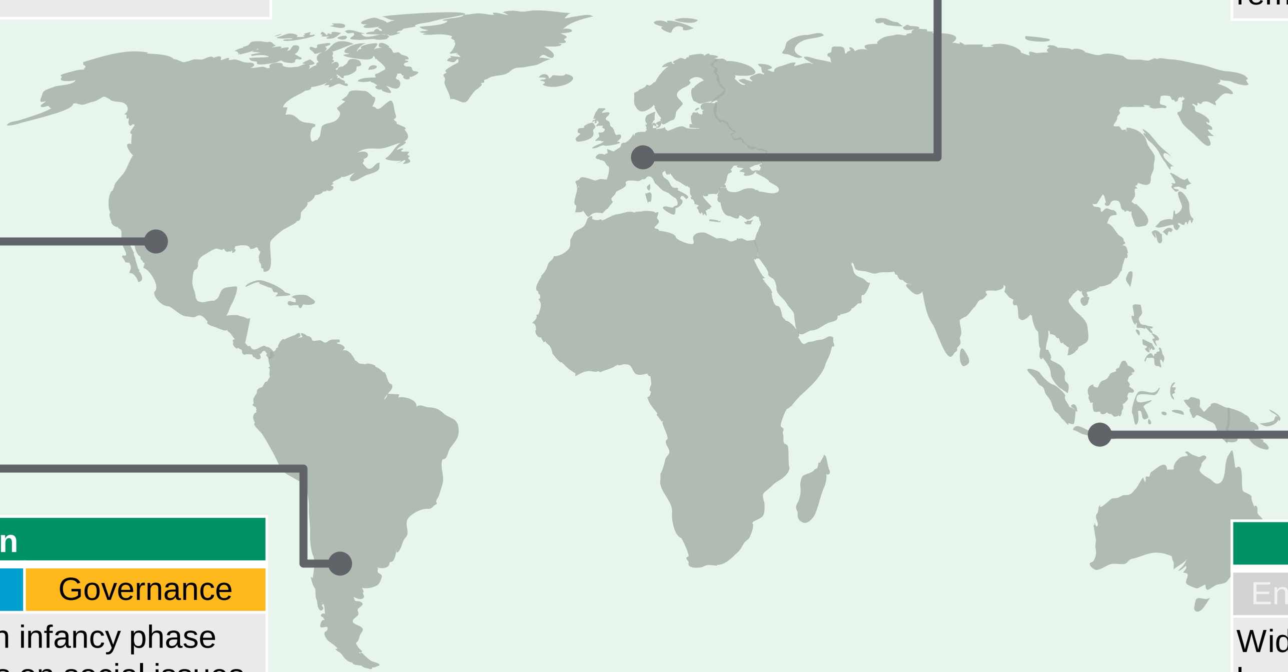
Environmental	Social	Governance

Mature corporate governance. Climate transition expected to be the spotlight in 2021 and beyond. Social issues such as HCG and DEI will likely continue momentum.

Western Europe

Environmental	Social	Governance

More companies have added climate measures to incentive plans. Regulators have taken a tougher stance on emissions. Some companies have removed to instate say-on-climate votes.



Latin American

Environmental	Social	Governance

Environmental discussions still in infancy phase and developing. Increasing focus on social issues such as DEI, safety and wellbeing. Governance practices continue to mature, driven by pressure from institutional investors.

Asia Pacific

Environmental	Social	Governance

Wide range of corporate governance maturity levels. Key focuses include: Board diversity, board composition and skills, formal non-executive selection and on-boarding process, and board effectiveness.

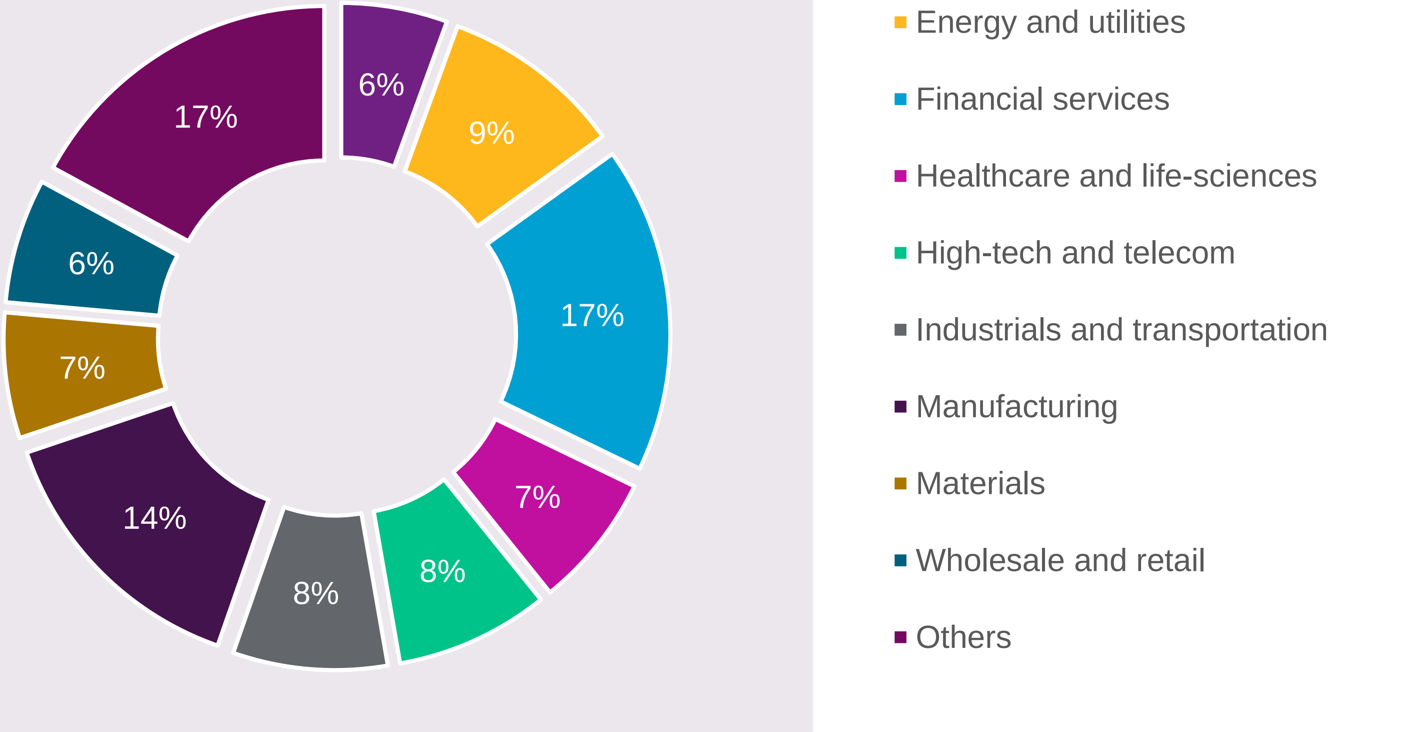
About our research

About the research –
338 responses from interviews and surveys

144		13	
Canada USA		Brazil South Africa UAE	
68		**113**	
Belgium Denmark France Germany Greece Ireland	Italy Latvia Luxembourg Netherlands Spain Switzerland UK	Australia China Hong Kong India Indonesia Japan	Malaysia Myanmar Philippines Singapore South Korea Taiwan Thailand

About the research – 338 responses from interviews and surveys

Industry breakdown



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To see all our related research, please visit:

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