The risks boards face when crafting ESG-related incentive plans

How soon is too soon?

Companies are increasing their commitments to improving performance on environmental, social, and governance (ESG) initiatives. Naturally, boards are looking to use incentives to ensure that executives pursue and are held accountable for these goals—as they have long used incentive compensation to enforce other strategic and financial objectives. But before designing an appropriate ESG incentive program, companies must be sure they have a well-defined ESG strategy that is embedded in corporate objectives and initiatives.

CEOs and boards of directors are under intense pressure from stakeholders to understand the ESG strategy and their role in effectively driving it forward. Showing real progress on environmental, social and governance is becoming an essential element of doing business today. Without meaningful commitment to ESG, organizations face real risks—the ability to attract capital and customers, collaborate with other businesses, and recruit and retain top talent.

How to make sure it happens? A critical step is building ESG into strategy and operations, rather than treating it as a separate, siloed activity. Drive the right behaviors and accountability by incorporating goals and targets into incentive plans, a time-tested approach for reinforcing commitment and alignment with company goals and strategy.

Indeed, many boards are already including ESG metrics in executive compensation programs and reporting on these rewards in public filings. Recent KPMG research shows that ESG reporting rates in proxy statements have doubled every year for the past five years. A 2021 study by Meridian Compensation Partners found that 58 percent of S&P 500 companies incorporate ESG metrics in annual incentive plans, and 5 percent include ESG metrics in long-term incentive plans.

Think carefully about ESG incentives

However, before committing to incorporating ESG metrics into incentive plans, boards should think carefully about how to craft the incentives to make sure they are effective. Poorly thought-out incentives can backfire, causing frustration among executives, confusing external stakeholders, and actually holding back ESG progress in the organization.

Boards should start by asking if the organization is actually far enough along the ESG journey to align ESG strategy with compensation? Does the board know which ESG issues are truly core to the business strategy and key to the long-term health and viability of the company? Has the board evaluated which ESG issues do customers, suppliers, and other internal and external stakeholders view as key to the company’s long-term strategy? Addressing such questions can help boards design ESG-related compensation programs that will work for the executives and the organization.

1Source: The role of finance in environmental, social, and governance reporting (ESG), KPMG US, 2021
2Source: Meridian Study on Use of ESG Metrics in Incentive Plans, meridiancp.com, May 25, 2021
Key risks

By setting incentive targets before an integrated ESG Strategy has been developed creates the following risks:

**Stakeholder confidence:**
Stakeholders include shareholders, customers, employees, and other interested parties, such as communities where the company operates. Without a clear ESG strategy—and certainly without a maturity and materiality assessment—the board may not have sufficient information and data to make public statements regarding ESG-related executive incentives. When there are frequent changes to public statements or incentive programs, stakeholders will likely lose confidence in the executive team and the ESG program.

**Employee frustrations:**
Executive incentives will help influence behavior across the entire organization. Laying out a well thought-through strategy with aligned metrics can motivate and drive change across the organization. Employees will be excited to hear about their organization's ESG related purpose, aspirations and how they can participate. However, a carelessly formulated incentive structure can create disappointment and frustration in the organization.

To address such risks, the following crucial steps should be taken before including ESG goals in executive plans:

**Assess:**
Identifying the current state of ESG is the first step in the journey. Prioritize critical areas and set an enterprise-wide ESG strategy that aligns with the broader business strategy and stakeholder expectations. Evaluate material areas and gauge the maturity of each to inform current positioning.

**Design:**
Strategize how ESG will be incorporated into the operating model of the company. Set specific targets and goals. Start to mitigate gaps in disclosure frameworks, processes, data, and governance.

At this stage, it is appropriate to include key ESG metrics in the executive pay program to emphasize the commitment to ESG. This also signals to investors and employees what is being measured. Deciding which metrics to include, whether the metrics are reflected in the annual or long-term plan, and how much impact ESG should have on overall rewards is a critical task for the board.

**Operationalize:**
Start by understanding the requirements to meet the outlined ESG commitments, then invest in the necessary capabilities (workforce, technology, infrastructure, and governance). Without the necessary people, processes, and technology in place, an organization will not be able fully execute or measure the performance of its ESG initiatives—effectively diminishing the benefits of the ESG strategy.

**Measure and report:**
Formalize the metrics to monitor the achievements of the ESG strategy. Track return on investment and progress against plan. Also keep track of changes in relevant standards and ratings frameworks that are to occur. The ability to develop and align consistent messaging (inside and outside of the Company) is essential to inform stakeholders about the 1) ESG Strategy, 2) processes in place to govern decisions, and 3) measures that increase awareness and buy-in from executives and employees.

Following these steps before aligning ESG metrics with leadership compensation plans prevents risks before they occur. It is important to remember that while incentive plans may feel like the next step for your company's ESG journey, boards must take a moment to pause and evaluate whether the organization's ESG strategy aligns with and is integrated into the corporate strategy and whether the incentive plan enforces the behavior that the board wishes to drive.
How KPMG can help

KPMG’s cross-functional team can cover each element of the ESG lifecycle. The KPMG People Strategy team consists of compensation professionals who combine their years of hands-on experience, industry knowledge, and data analysis to assess pay levels, mix, and design practices for public and privately held organizations. Our cross-functional team provides the expertise necessary to handle ESG enterprise-wide, design a relevant and purpose-driven incentive program, and support the rollout of communications of the ESG strategy and go-forward incentive plans vital to driving key behaviors and business objectives.

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