Addressing the missing link between purpose and pay to enhance progress and credibility

The need for responsible remuneration is now. The global environmental, social and governance (ESG) landscape is complex, with many forces unintentionally creating organizational confusion regarding sustainability requirements, definitions and KPIs. Despite these uncertainties, a unique opportunity exists for boards and executives to influence companies' societal impact and enhance long-term value creation by evolving their reward policies toward sustainable remuneration.

Prior to the COVID-19 pandemic, corporate ESG discussions focused almost exclusively on climate change and the environment. Today, the health, economic and supply chain impacts of the pandemic have prompted a seismic shift in the understanding of the critical importance of each ESG category that has elevated the importance of the social and governance components.

Corporate stakeholders have also contributed to the placement of ESG either at, or near the top, of boardroom agendas. From regulators requiring the achievement of ambitious ESG targets along with strong ESG governance and disclosures, to investor demands for increased integration of sustainability into investment decision-making, organizations seek to strike a balance between taking a "wait and see" ESG approach or acting quickly now and running the risk of tying themselves to targets that are difficult to modify in the future without adverse consequences.

Employees too are playing increasingly influential roles in shaping the ESG priorities of their employers.

- According to the EY 2022 Work Reimagined Survey, 29% of employees tie their employment decisions to a company's purpose, culture, ESG goals, diversity and inclusion priorities.

- As per WeSpire's 2021 State of Employee Engagement Report, 93% of employees who viewed their employer as making a strong positive impact in the world are planning to stay in their current roles.

An organization's ESG commitment rarely includes sustainable remuneration elements

Against this backdrop, many companies say that they are prioritizing ESG. Yet their current approaches toward embedding ESG into the fabric of their organizations and being able to demonstrate that they are "walking the talk" remains fragmented. While many organizations have included ESG within their purposes and business strategies and are reporting on their progress through recognized ESG frameworks, such as the Global Reporting Initiative (GRI), Sustainability Accounting Standards Board (SASB), the UNGC SDGs, or the World Economic Forum Stakeholder Capitalism Metrics; few, however, have cascaded ESG through their remuneration and total rewards governance programs.

In 2022 EY conducted a global analysis of remuneration disclosures of 229 of the largest publicly traded organizations, spanning 13 countries and 6 primary sectors, to evaluate the prevalence of ESG metric utilization within variable remuneration schemes. Our global market scan yielded the following observations:

- **Minimal and inconsistent ESG disclosures:** There is minimal quality disclosure detail on the ESG metrics deployed in variable remuneration schemes i.e., limited detail on ESG metric definition, target performance levels, metric calibration (threshold/ target/ max) and scorecard weighting.
- **Geographical and sector variability:** ESG variable remuneration scheme metric disclosures vary significantly by both geography and sector.
- **Short term ESG focus:** Most organizations incorporate ESG metrics into annual incentive plans (AIPs) rather than long-term incentive plans (LTIs).

As the criticality of an organization's ESG agenda within its broader business strategy continues to expand, one would expect that individual performance goals and variable remuneration scheme metrics would reflect the expanding importance of ESG KPI achievement. Said differently, if the organization's leadership involved in developing and implementing an organization's ESG strategy aren't aligned with the achievement of their stated goals through their variable remuneration, stakeholders may question the organization's commitment to achieving their ESG agenda.

Any misalignment in an organization's ESG narrative compromises its credibility and trustworthiness. Given that annual Directors Remuneration Reports are the most read element of an Annual Report and one of the most highly scrutinised items in the news, organizations need to pay urgent attention to remuneration as a fair and accurate reflection of the ESG agenda they are delivering.

How organizations and boards need to respond

Expectations are high for organizations to take decisive ESG actions now that are aligned with their corporate strategy, purpose, and long-term value creation. As the global ESG ecosystem continues to evolve, we believe a compelling role exists for organizations to make meaningful progress on their ESG agendas by embracing the following sustainable remuneration initiatives:

- **Enhanced utilization of ESG metrics within variable remuneration:** ESG is a shared responsibility across an organization. To supplement the traditional prioritization of financial metrics within variable remuneration, leading organizations are introducing 1-2 material ESG metrics into their variable remuneration schemes. This is happening not only at the executive level – using balanced scorecards but also cascading throughout the broader workforce. Employees are telling their employers that this matters to them and cascading ESG targets into broader variable pay schemes can demonstrate they are being listened to.

- **Expanded sustainability leadership capability demands:** Gone are the days when one executive has sole responsibility for an organization's sustainability initiatives. CEOs, CFOs, CSOs, CHROs and many other leadership roles now have shared accountability for ESG outcomes. We are seeing an increasing need for Remuneration Committee members' ESG knowledge and expanded remit for them to play an active role in Board discussions to drive management outcomes and consider variable remuneration as an important lever in driving progress.
- **ESG disclosure harmonization & purpose linkage:** Rather than treating each disclosure document as a stand alone filing, a compelling business case exists for harmonization and simplification of ESG-related filings (e.g., strategic, sustainability & remuneration reports) to enhance the alignment and coordination and transparency of the individual filings.

A global ESG framework of sustainable remuneration guiding principles can help organizations create a comprehensive narrative for stakeholders

As we look ahead, we believe there is a need for a consistent, global ESG framework of guiding principles that can help organizations create meaningful variable remuneration schemes that include well-defined and reportable ESG metrics. EY and Reward Value Foundation believe these principles can have significant benefits across all functional areas of an organization. Installing sustainable remuneration policies encompasses more than just including some ESG metrics. It requires a detailed process of key design steps to ensure an effective remuneration policy in support of the company's purpose, strategy, and long-term value creation. EY and Reward Value Foundation have developed such a clear process.

For example, material KPIs can incentivize CEOs to sufficiently prioritize ESG when setting organizational strategy and targeted DEI outcomes, allowing ESG progress to compete with shorter-term financial measures. Further, we believe that it will be important for:

- CFOs to apply a sustainability lens more consistently to funding allocations and investment decisions.
- CHROs to leverage a proactive ESG agenda to attract and retain top talent.
- CSOs to achieve greater visibility relative to competing corporate priorities and have more opportunity to accelerate ESG progress across the organization; and
- Employees to benefit from a strong baseline of environmental, social and governance standards that support a safe, fair, and equitable working environment, and a plan for decarbonization that feeds a belief in a greater purpose that many employees look for from their employers.

We will soon be releasing our proposed global framework and eight guiding principles for sustainable remuneration. Stay tuned!

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