Executive Remuneration Briefing Part 2: Boardroom pay: All the way to the top

Posted by Ben Schiller [1] on Mar 5, 2012

Longer-term targets linked to longer-term rewards for bosses are crucial if we want a longer-lasting planet

Paying executives to manage sustainability is widely seen as a mark of a company's seriousness on the topic. And this needs to start at the top.

Ruth Bender, a compensation expert at Cranfield School of Management, says that if companies have environmental measures throughout the organisation, but not in the C-suite, then there is no chance of carrying out change in corporate culture.

"There is a question of whether money does motivate people. But if you are going to incentivise through pay policies, you have to include bosses as well as employees," Bender says. "You need to set the example from the [boardroom], and you have to make it a serious amount."

So, what is best practice when paying senior executives to manage environmental, social and governance (ESG) issues?

Andrea Moffat, at Boston-based group Ceres, says there are no hard-and-fast rules. "There is a lot of variability in how companies are doing it, and that's OK."

Naturally, companies are going to incentivise the management of different things, depending on what is relevant and important to them. There is no point a computer manufacturer, say, requiring directors to watch out for oil spills.

But, in general, Moffat says there are practices that separate companies that are really following through from those that are simply paying lip-service.

The best tie specific portions of the pay packet to specified sustainability targets, she says. They make sure the amount at risk is "meaningful". They include not only executives, but also employees further down the management chain. They disclose how the incentive plan works, so "investors get a sense of the proportion at risk". And, they make disclosures in both regulatory filings and sustainability reports.

While a large number of companies now have some link between executive pay and sustainability, there is a lot of variability both in how the link is made, and how it is disclosed.

Disclosure

Many companies are like New Jersey-based Campbell's Soup, which is incentivising for ESG issues. But full details about how it is doing so, and to what extent, are not always straightforward to find.

Dave Stangis, Campbell's vice-president for corporate social responsibility and sustainability, told Boston Consulting Group and Sloan Management Review recently that his company had incorporated sustainability into employee reviews. BCG/MIT's third annual Sustainability & Innovation Global Executive Study praised this as a sign that sustainability had reached "a tipping point" at major companies.

Stangis said: "In the workplace, we went from not having specific sustainability objectives in employee performance reviews to integrating clear corporate targets that make CSR a standard component of managers' performance evaluation."

And yet, as a leader on these issues, both Campbell's most recent proxy filing (from November 2011), and latest corporate responsibility report released in 2011, could provide more of a deep dive into what the company is actually doing.

The corporate responsibility report says sustainability metrics are part of a "balanced scorecard" used to decide compensation for executives and managers. "Objectives range," it says, "from specific steps in strategy development to individual reporting milestones, such as establishment of agreed-upon metrics, expansion of community service programmes, workplace diversity and inclusion, and supplier diversity and safety."

Speaking to Ethical Corporation, Stangis says that this is an "evolving topic" for Campbell Soup "as we evolve as a company". He argues that Campbell has had "specific measures with actual sustainability resource improvements" in place since 2011. The company has expanded performance objectives for all employees to be "inclusive of social responsibility, safety, inclusion and ethics".

Could there be more detail? Currently, Campbell is in a process of "re-evaluating the entire scorecard and compensation influencers", Stangis says, "with the goal of making the inclusion of sustainability and ethical metrics a cultural norm".

Certainly, experienced social responsible investors and analysts, such Paul Hodgson at GMI Ratings, say detail is important. It's one thing to say you are reducing emissions, it's another thing to say by how much.

"If you have a real target that you are holding managers to, the best thing is to disclose it so that people understand that it's a real target," Hodgson says.

Strength of links

The food and drinks sector tends to have a "weak link" between executive compensation and sustainability or ethical issues, according to San Francisco-based proxy advisory firm Glass Lewis's 2011 Greening the Green report.

Danone and Unilever – the latter of which, of course, operates in other sectors too – have similar approaches. Danone splits its executive bonus into thirds, with economic performance, management, and "societal criteria" driving equal shares. Unilever awards its executives for underlying volume growth, operating margin and trade working capital improvement. Its compensation committee then assesses the quality of performance, including leadership and corporate responsibility.

Companies with "medium" links, including PepsiCo and Tullow Oil, disclose the percentage of bonuses subject to responsibility metrics. For example, Pepsi awards a third of its bonus based on "performance with purpose" priorities, including environmental sustainability.

Those with "strong" links tie financial rewards directly to specific responsibility or sustainability targets. For example, the German energy company RWE links 45% of its executive bonus to an internal, and independently evaluated, "corporate responsibility index" that tracks the group's performance in 10 areas. A further 10% is assessed against a similarly managed "employee motivation" index.

Glass Lewis found that the strength of pay-sustainability links is tied to how companies manage sustainability in other ways. For example, it sees a tight correlation between S&P 100 companies with sustainability committees (outside of the audit, compensation, nominating and governance committees) and those with strong compensation links. Seventy-one per cent of strong-linking companies, and 53% of linkers overall, had such structures.

In other words, companies that do the best job of paying executives for sustainability are likely to be those that already take sustainability seriously. Sustainable executive pay is a reflection of an overall approach.

Courteney Keatinge, senior ESG analyst at Glass Lewis, identifies Alcoa, the US aluminium producer, as a company that has both strong links on pay, and a strong management structure to oversee ESG issues. Of bonuses, 21% are dictated by sustainability (including 10% for diversity, 5% for safety, and 5% for environmental performance), and the company has an executive-level global sustainability steering team and chief sustainability officer.

Paying for the long term?

Ruth Bender says it is increasingly common for companies to spread out bonuses over several years. For example, since the Deepwater spill, BP has deferred its executive bonuses over three years. If managers hit certain targets – including for environmental performance and safety – their bonuses are topped off with extra shares, effectively doubling the award.

“I think BP changing their pay policies to highlight safety and risk management and environmental best practice was something they had to do,” Bender says. “There is no way they could have proceeded without doing that. I think what you find is that companies in polluting industries pay a lot more attention to this.”

RWE also sets aside 25% of executive bonuses for three years, complying with a 2009 German law on executive compensation that demands longer-term pay. Executives only get this portion if the supervisory board deems the business to have “developed sustainably”.

Longer-term pay is more prevalent even in the financial services industry, long a hotbed of short-termism. Mercer’s most recent Pan-European Financial Services Remuneration survey found that 67% of companies deferred bonuses in 2010, up from 45% the year before. Part of the reason for the shift is regulatory. The UK’s Financial Services Authority published its Remuneration Code in 2010, saying – among other things – that at least 40% of variable compensation should be deferred. Its rubric covers 2,500 companies.

In the Netherlands, paint giant Akzo Nobel bases half of its long-term executive pay on the company’s ranking in the Dow Jones Sustainability Index for chemicals companies. Managers get the full bonus if they finish in the top three of 90 companies; less if they come in fourth or fifth.

And three other Dutch companies – DSM, a life sciences group, logistics operator TNT, and banking giant ING – also have sustainability-pay ties. DSM’s plan covers customer and employee satisfaction, energy use and greenhouse gas emissions. Managers must hit targets to get their bonuses.

The shift to sustainable metrics in pay is undeniable. But it seems that not all the targets are tough all of the time. In 2010, the Sustainable Investment Forum’s Remuneration Theme Report revealed that 29% of the FTSE Eurofirst300-listed companies had sustainability links. But it found many targets were too “soft” – meaning executives had little trouble meeting them.

Case study: Xcel Energy

Xcel Energy, based in **Minneapolis**, is a large **power producer** and transmission line operator. It incentivises its managers to manage sustainability, and provides an exemplary level of disclosure, according to several observers.

The 2011 proxy filing lays out exactly how performance incentives were awarded the previous year. There was a **three-way split** between “enhance environmental performance”, “improve employee safety”, and “meet earnings target”, with goals in each category, along with targets and actual performance levels.

So, for example, carbon emission reductions made up **10%** of the overall award. The target was to retire **73MW** worth of capacity, and the actual performance was 73MW, plus the elimination of 488,931 tons (US) of CO_2 equivalent. Having overachieved, the executives therefore received **148.9%** of the originally anticipated bonus.

Writing in the Harvard Business Review, **Mindy Lubber**, president of Ceres, praised the level of disclosure. “First, such disclosure gets the key information directly to the people who need it most – the investment community – in the place they’re most likely to see it,” she said. “Second, it demonstrates that Xcel sees sustainability as a core business issue.”

The strategic role of non-execs

With responsibility for **overseeing** and signing off the pay offered to executive directors, **non-executive directors** have a key role in deciding whether a company incentivises for corporate responsibility outcomes.

Rory Sullivan, strategic adviser at Ethix SRI Advisers, and a senior research fellow at the University of Leeds, says there are three things they should be doing.

First, he says, they need to ensure that sustainability issues are fully integrated to **corporate strategy** and risk management processes.

Second, they should require that CR issues are properly incorporated into executive **remuneration** schemes.

And third, they should hold executives to **account**, ensuring that actual payments reflect **performance**.

Ten years ago the issue was all about aligning executive with **shareholder interests**, so that managers were paid for performance. The question now, though, is whether this principle may have blocked off discussion of other important considerations regarding pay.

“The first is whether shareholder interests are the primary interests companies should take account of, or should they be required to account for wider **societal values**,” Sullivan says.

“The second is that while boards have done a good job on alignment, significant questions remain about the **absolute level** of executive pay, which seems to have soared ahead of average incomes within many companies.”

With the recent controversies over excessive pay, and greater calls for incorporation of **corporate responsibility metrics**, non-executives are sure to be at the heart of boardroom debate in the years ahead.

Links:
[1] http://www.ethicalcorp.com/users/ben-schiller