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Ask the Expert.

The ESG Impact on Executive Compensation

Matt Turner, *Managing Director*

The following is based on a conversation with Matt Turner, managing director in Pearl Meyer's Chicago office.

Q. Recently ESG (environmental, social, and governance) issues have gained increasing traction in corporate boardrooms. Has there been an impact on executive compensation?

A: Yes, in various ways, ESG issues are showing up in the performance framework of executive incentive compensation and, more broadly, in executive performance evaluation. With respect to incentive plans, ESG issues may show up as modifiers to the overall funding of executive cash incentives. Alternatively, if the specific issue can be attributed to key individuals, or component metrics of the overall goal can be identified, they may show up in the individual performance portion of an incentive plan.

Q. How influential are ESG metrics in executive incentives?

A: Typically such metrics are given only modest weight in the overall incentive funding formula—something along the lines of 10-20% of the total. The modest weighting may be due to the amount of practical control and influence an executive team may have over the goal. Somewhat related, objective measurement of progress or success may be difficult, requiring subjective judgement. While the actual weight may be modest, the important thing is the signal being sent both to the executive team and the external stakeholder community about the importance of the issue.

Q. You mentioned "executive performance evaluation" separate from incentives. What are you referring to?

A: ESG issues are increasingly showing up in executive performance evaluations, especially those for the CEO. Governance issues (the "g" portion of ESG) have long been a part of the CEO evaluation, with board relations, leadership, and compliance matters taking up a significant portion of the overall scorecard. But now the big environmental, social, and sustainability issues are starting to show up as well. As mentioned earlier, many ESG goals require extensive subjective evaluation. For example, diversity goals today cannot appropriately be reduced to sheer numbers. Yes, ultimately a company goal may be to see more diversity on the board and among senior leadership. But it matters immensely how the company gets there. And less tangible goals, such as "reflection of consistent values throughout the organization," simply cannot be reduced to a quantifiable metric. Because of this trend, boards are finding they must invest more time in the CEO evaluation process.

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Q. How are boards coping with this increased commitment of time and attention to CEO evaluations?

A: For a long time experts in executive performance evaluation have preached the need to engage in dialogue and provide feedback more often than once a year. It seems with respect to CEO evaluation, the message is getting through to boards. Today nearly half of large public corporations formally review CEO performance more often than annually, typically on a quarterly basis, or at each meeting of the board in executive session. Such frequent meetings on CEO performance can be time consuming. For this reason, we typically recommend that the focus be placed only on those aspects of the evaluation that require subjective evaluation and the balancing of many performance dimensions. ESG issues fall squarely into this bucket.

About Matt Turner

Matt Turner is a managing director in the Chicago office of Pearl Meyer. He specializes in advising company boards and senior management on executive compensation strategy, incentive plan design, tailoring of performance measures, and the setting of shareholder-focused performance objectives.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management on the alignment of executive compensation with business and leadership strategy, making pay programs a powerful catalyst for value creation and competitive advantage. Pearl Meyer's global clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private companies to the Fortune 500 and FTSE 350. The firm has offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, London, Los Angeles, and San Jose.

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