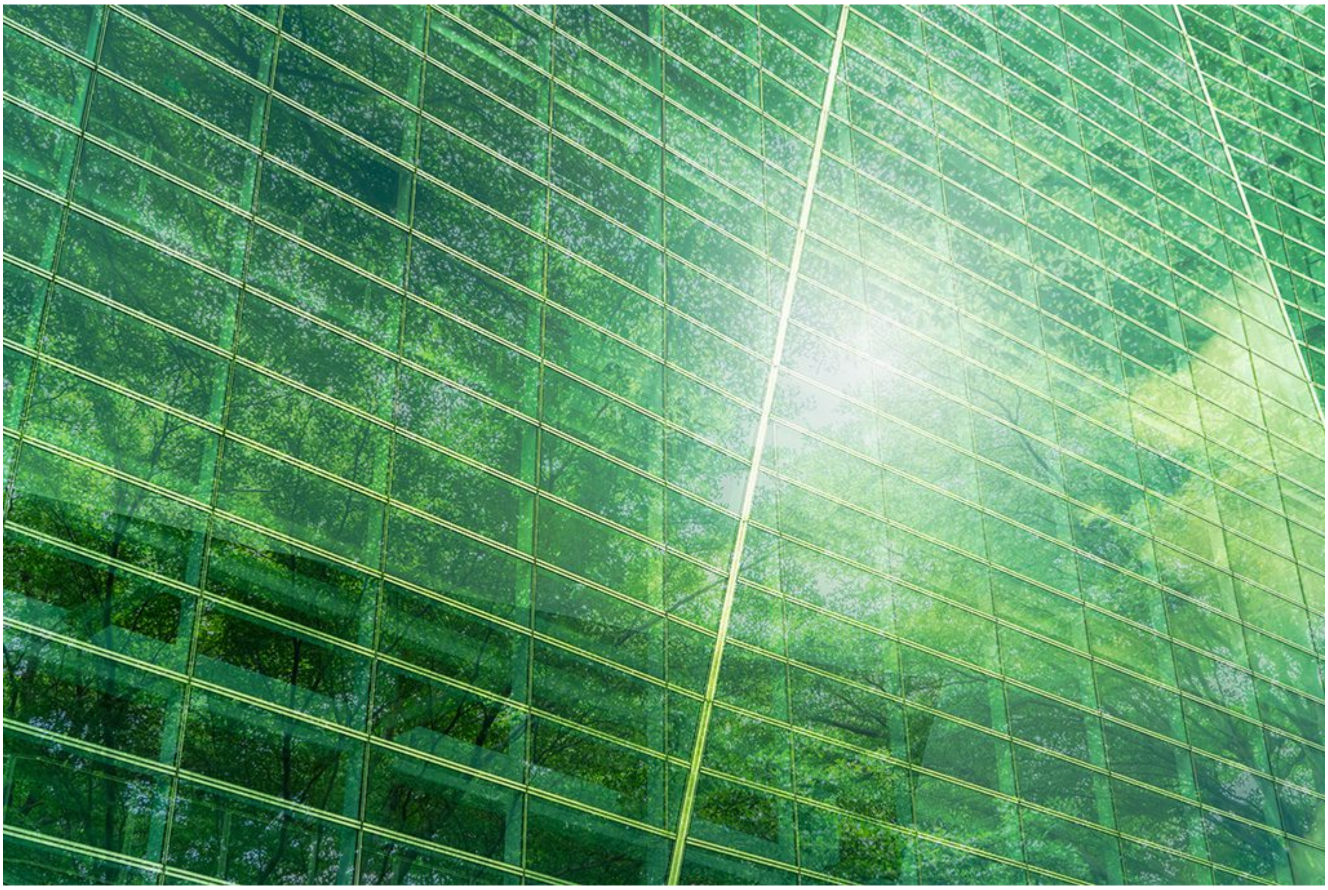
ESG-linked executive pay is on the rise, which is good news for the planet

A global study finds 38% of companies now tie compensation to ESG goals, resulting in real improvement in firms' environmental performance.



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More and more companies, especially in Europe, are linking executive compensation to environmental, social and governance (ESG) criteria. That's good news for the planet — but

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not for near-term profits.

A global study looks at the prevalence of ESG-linked pay for executives, and where and which companies are adopting the practice. The research examines the role of institutional investors in encouraging ESG pay, as well as its impact on firm performance.

The conclusion: ESG pay is surging across industries, and especially in those sectors with high environmental impact. There is emerging evidence that ESG pay — if structured carefully and correctly — can serve as an effective tool for lowering companies' carbon emissions and supporting their long-term health. But there's no indication that ESG pay benefits financial returns or stock prices in the short term.

The study, based on data from nearly 4,400 firms in 21 countries, was conducted by IESE's Gaizka Ormazabal and Igor Kadach, together with Shira Cohen of San Diego State University and the University of Mannheim's Stefan Reichelstein.

Where ESG pay is being adopted

Crunching the data, the percentage of listed firms linking executive pay to ESG performance jumped to 38% in 2021 from just 1% in 2011.

The inclusion of ESG metrics in compensation contracts is more common in countries that are generally more sensitive to ESG issues and have stricter regulations — such as those in the European Union, where 60% or more of companies use them. In contrast, the U.S. has one of the lowest percentages of firms incorporating this metric (only 16.5%).

Firms operating in industries with high environmental impact are more likely to tie their executives' salaries to ESG goals. Among the industries where it's most common are petroleum and natural gas; utilities; and non-metallic and industrial metal mining.

Companies incorporate ESG pay for a range of reasons:

- as an incentive to safeguard the company's economic results, since ESG metrics are viewed as indicators of future financial performance and potential risks;
- because it aligns managerial objectives with the interests of shareholders and other stakeholders;
- because ESG pay strengthens a company's other green credentials, such as pledges to improve environmental performance.

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It also matters whether institutional investors throw their considerable weight behind climate, social and corporate governance issues. Engagement by the three largest institutional investors (BlackRock, State Street and Vanguard) tends to increase the likelihood that a firm will implement ESG pay.

Impact of ESG pay on emissions and finances

In terms of subsequent outcomes for ESG adopters, the study finds that these firms tend to experience reductions in their CO2 emissions — a key environmental metric and evidence that the practice can produce real impact. They also receive, on average, more favorable ESG scores from outside rating agencies.

But the effect of ESG pay on financial performance is less clear-cut. The study finds no positive association with financial outcomes such as return on assets, and even finds a decrease in stock returns after the adoption of ESG pay.

That means ESG pay isn't a path to short-term gains. Instead, ESG pay in executive compensation schemes is valuable to the extent that it says something about future financial performance that financial metrics (accounting data's limited ability to incorporate forward-looking and intangible information) and stock prices (because of reliance on market efficiency) are unable to.

About the research

The data analyzed is based on the ISS Executive Compensation Analytics database, covering a sample of 4,395 public firms from 21 countries between 2011 and 2020. "Executive compensation tied to ESG performance: international evidence" was published in the *Journal of Accounting Research.*

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