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DOING WELL BY DOING GOOD?

In this bulletin, we look across the 2021 AGM season, considering the increase in the use of performance targets intended to incentivise employees to improve the environmental, social and governance performance of the U.K.'s largest public companies.

The 2021 AGM season has already seen the UK's largest companies report a marked increase in the use of targets relating to their environmental, social and governance ("**ESG**") performance in their executives' pay packages. Approximatively half of the FTSE 100 now use an ESG metric in some form when determining their directors' variable remuneration.

We reported last year that, whilst there was considerable debate around tying executive pay to ESG metrics, relatively few companies had then reached the point of incorporating such arrangements into their remuneration frameworks (albeit with some notable exceptions, mainly in the energy and resources sector, such as Royal Dutch Shell plc).

Now, in 2021, that talk has turned into action. Based on pay arrangements disclosed in FTSE 100 annual reports published for the 2020 financial year, around 45% of FTSE 100 companies now have some form of ESG input into their executives' pay, compared to less than 20% last year. That said, the proportion of management's incentive awards that are subject to ESG targets is, at the moment, relatively minor, constituting around 15% of the overall award on average.

It is clear that the presence of ESG targets in the mix of performance indicators is increasingly on the agenda of the UK's major shareholders. The most recent executive remuneration guidance from the Investment Association (the "**IA**") published at the end of 2020 expressly states:

"Remuneration committees should consider including strategic or non-financial performance criteria in variable remuneration, for example relating to environmental, social and governance (ESG) objectives, or to particular operational or strategic objectives. ESG measures should be material to the business and quantifiable. In each case, the link to strategy and method of performance measurement should be clearly explained".

This sentiment has been echoed in the voting guidance issued independently by certain major institutional shareholders, such as Schroders. Shareholders' expectations therefore boil down into three key priorities (which may come into conflict in practice):

- That the ESG metrics are relevant to the individual company;
- That the ESG metrics are robust and capable of audit (shareholders are particularly wary of non-financial targets being used to increase annual bonus outcomes in years where the company's financial performance does not merit the payment of a bonus); and
- That the targets, and the company's performance against those targets, is fully disclosed to shareholders (shareholders are mindful of the fact that a material proportion of listed companies do not disclose, or only disclose on a retrospective basis, their annual bonus targets in their annual directors' remuneration reports on the grounds that these targets are commercially sensitive as they may indicate to the company's competitors the company's short-term objectives and performance expectations).

Across the FTSE 100, "social" measures remain the most common ESG metrics overall. That said, the nature of disclosed ESG targets is becoming more diverse, covering other issues of concern to shareholders, employees and society as a whole such as climate change, sustainability and diversity, alongside the more established measures of employee engagement and health and safety.

The most common "social" targets disclosed relate to diversity/inclusion targets and can clearly be said to be satisfying the IA's requirement of being verifiable by shareholders. One of the most frequently used targets is a metric assessing what proportion of senior management positions are held by individuals who are female or identify as LGBTQ+ or BAME.

However, remuneration committees are rightly mindful of ensuring that the desire to have metrics which are objectively assessable does not have the unintended consequence of leading management's focus away from the actions and behaviours that are necessary to delivering the company's particular ESG priorities. There is therefore an increased focus on performance measures that are capable of independent third party audit, particularly in the environmental sphere, in areas such as carbon capture.

It is evident that the push by shareholders and other stakeholders to incorporate ESG priorities into directors' remuneration packages has had significant traction over the 2021 AGM season. However, these targets should not seen in a vacuum. Fundamentally, ESG metrics in the executive pay framework are only going to deliver the maximum benefit to the extent they dovetail with the company's ESG strategy as a whole. The introduction of ESG metrics should therefore be seen as related to, and a natural consequence of, the company implementing its overall ESG aspirations (to reward management for their successful implementation), rather than as a standalone matter.

If you would like to discuss any of the issues referred to in this briefing please contact one of the individuals listed below or your usual Slaughter and May contact.

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