

ESG metrics in compensation plans

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In a May 2022 [Insights](#), we shared our views on the use of environmental, social, and governance (ESG) metrics in compensation plans. In that piece, we shared that Vanguard Investment Stewardship, on behalf of Vanguard-advised funds, does not expect companies to incorporate ESG metrics into their executive compensation plans.¹ However, if a company chooses to include ESG metrics in executive compensation plans, we look for the same level of diligence to be applied as we do with traditional financial metrics.

We have observed a growing number of companies in the U.K. and Europe adopting ESG metrics in executive compensation plans, with these metrics increasingly determining a meaningful proportion of payments. We anticipate that more companies may adopt the use of ESG metrics in their executive compensation plans in response to the evolving landscape in the U.K. and Europe.

Regulatory frameworks, governance codes, and guidance from industry bodies in the U.K. and Europe increasingly encourage companies to create linkages between compensation and sustainability goals. In addition, engagements with portfolio company leaders have revealed that there is an increase in the number of shareholders calling for the mandatory inclusion

of ESG metrics in incentive plans. In some cases, shareholders have indicated that they will vote against "Say on Pay" proposals when ESG metrics are not included or not materially weighted.

While many companies continue to take a thoughtful and transparent approach to setting targets and disclosing metrics in compensation plans, we have seen some instances wherein ESG metrics in compensation programs at companies in the U.K. and Europe are not disclosed, poorly defined, or not linked to material risks/opportunities with clear ties to long-term investment returns. This Insights piece shares our perspective on the inclusion of ESG metrics in compensation plans for companies that choose to include such metrics.

Our views on including ESG metrics in compensation plans

We do not believe there is a one-size-fits-all approach to executive compensation. We encourage portfolio companies to adopt pay plans that incentivize outperformance versus industry peers over the long term and align executive compensation outcomes with shareholder outcomes.

¹ Vanguard's Investment Stewardship program is responsible for proxy voting and engagement on behalf of the quantitative and index equity portfolios advised by Vanguard (together, "Vanguard-advised funds"). Vanguard's externally managed portfolios are managed by unaffiliated third-party investment advisors, and proxy voting and engagement for those portfolios are conducted by their respective advisors. As such, throughout this document, "we" and "the funds" are used to refer to Vanguard's Investment Stewardship program and Vanguard-advised funds, respectively.

Vanguard-advised funds are more likely to support plans in which a majority of executive compensation is variable, or "at risk," with rigorous performance targets set over a long-term time period. We look for companies to provide shareholders with confidence in the link between executives' incentives and rewards and the creation of long-term investment returns through effective disclosure of executive compensation practices.

We look for all metrics utilized in compensation plans—whether financial or nonfinancial—to be rigorously designed, thoroughly disclosed, and tied to long-term performance goals related to strategic objectives or material risks. We caution against using ESG metrics to signal a commitment to sustainability values. Although we understand the appeal of a test-and-learn approach to the inclusion of ESG metrics, we look for portfolio companies to map key ESG opportunities and material ESG risks for their business and to develop relevant internal and external reporting before ESG metrics are included in executive compensation plans.

ESG metrics and pay-for-performance considerations

On behalf of Vanguard-advised funds, we holistically look at executive compensation for evidence of pay-for-performance alignment; the funds may vote against pay proposals where we find that the link between pay and performance is weak, or has weakened, over time. Poorly constructed ESG metrics could result in inflated pay relative to performance. Examples of scenarios involving ESG metrics that may cause concern and impact the funds' voting decisions include:

- The introduction of ESG metrics that are not clearly aligned to company strategy.
- The inclusion of ESG metrics that are not linked to a financially material risk or opportunity, even where targets are quantifiable or clearly disclosed.

- The introduction of ESG metrics without the disclosure of comprehensive definitions.
- Increased weightings placed on ESG metrics or replacing financial metrics with ESG metrics without a disclosed compelling rationale.
- Year-over-year optimum achievement of ESG targets. This may raise concerns over the rigor of plan design, including the level of rigor in the established ESG targets. This concern may be exacerbated when ESG metrics are not quantifiable or clearly aligned to a company's annual reporting.

Our views on best practices for ESG metrics

We suggest that compensation committees consider the following practices if they are looking to incorporate ESG metrics in executive compensation plans:

Focus on materiality

Compensation committees may want to consider mapping ESG metrics explicitly to a framework assessing the materiality of various ESG matters to the company. Such a framework could be used internally and/or disclosed to shareholders. Companies can consider using external frameworks, such as the framework provided by the Sustainability Accounting Standards Board (SASB),² as a starting point when developing their own ESG materiality frameworks.

Alignment to appropriate time horizons

Although we have observed that most ESG metrics were initially included in short-term incentive plans, we have noticed that ESG metrics are being introduced more frequently into long-term incentive plans. We are not prescriptive as to whether ESG metrics should be included in short-term or long-term incentives, but we have identified opportunities for companies to provide more robust rationale for the inclusion of goals that are long-term in nature—such as medium- to long-term carbon reduction targets—in long-term incentive plans.

² The SASB standards are currently being incorporated into global sustainability reporting standards under the International Sustainability Standards Board, established by the IFRS Foundation.

As with other metrics included in long-term incentive plans, we look for clear disclosure of quantifiable targets and progress against those targets over time.

Robust disclosure

We look for portfolio companies to clearly explain their choice of ESG metrics and to demonstrate their alignment to opportunities, material risks, and the creation of long-term investment returns. When using qualitative ESG metrics in short-term incentive plans, companies should consider disclosing a robust explanation of the board's assessment of achievements annually or disclosing a clear scorecard assessment. Compensation committees' use of discretion should be clearly disclosed and accompanied by a compelling rationale. When changes are made to ESG targets, these changes should be clearly communicated to investors, highlighting any consequent effect on compensation.

Stretch targets

Compensation committees may set stretch targets to ensure that executives are incentivized to outperform on either an absolute or relative basis. Portfolio companies may want to rely on quantitative rather than qualitative targets to demonstrate that targets are sufficiently challenging.

Use of underpins or modifiers where appropriate

We have observed that some companies' plan designs include a requirement that certain milestones must be achieved before the incentive plan formula is operative (commonly referred to as an underpin), among other modifiers for risk mitigation metrics. Use of underpins or modifiers may help avoid the unintended consequence of rewarding negative outcomes such as fatalities or product recalls. Conversely, some portfolio companies use a financial underpin for standalone ESG metrics to avoid pay-for-

performance misalignment. To maintain a focus on financial metrics, other companies have used ESG metrics as a modifier to reduce or increase outcomes based on performance against financial metrics.

Thoughtful approach to external indexes

Companies that assess their ESG performance using external indexes should consider that the methodologies underlying them may change, resulting in ranking changes for reasons outside of the company's control. In our engagements, portfolio company leaders have mentioned that they rely on external indexes as a point of validation as their company matures its approach to ESG metrics and ESG more broadly. We have seen some of these companies go on to develop more tailored internal benchmarks to incentivize performance against operational ESG goals. We believe that companies using internally created indexes should clearly disclose how internal indexes are formulated. In general, we have observed that the pay-for-performance alignment between ESG opportunities and material risks and metrics is less clear when using metrics based on broad-based indexes, whether internal or external.

Typical questions for boards

While we observe the increased inclusion of ESG metrics in executive compensation plans in the U.K. and Europe—in part due to regulatory guidance and input from some shareholders—we continue to encourage boards to ensure that all metrics utilized in compensation programs are aligned with company strategy and focus on long-term investment returns. We look for boards to employ good corporate governance practices—including the practices noted above—when incorporating ESG metrics into executive compensation plans.

Below are the types of questions Investment Stewardship representatives may ask company leaders about the inclusion of ESG metrics in executive compensation plans:

- How does the board determine the materiality of risks to long-term investment returns? Can you share more insight into your materiality assessment?
- Can you explain how the chosen ESG metrics are key drivers of long-term business performance and investment returns? How do they represent the most material ESG risks/opportunities for your company?
- How have you determined the time horizon of the metrics chosen in your plans? Why have certain metrics been aligned to long-term incentives versus short-term incentives?
- How do you ensure that the targets set are robust, ambitious, and, where appropriate, independently verified?

Vanguard publishes Investment Stewardship Policy and Voting Insights to promote good corporate governance practices and to provide public companies and investors with our perspectives on important governance topics and key votes. This is part of our growing effort to enhance disclosure of Vanguard's investment stewardship voting and engagement activities. We aim to provide additional clarity on Vanguard's stance on governance matters beyond what a policy document or a single vote can do. Insights should be viewed in conjunction with the most recent region- and country-specific voting policies.

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