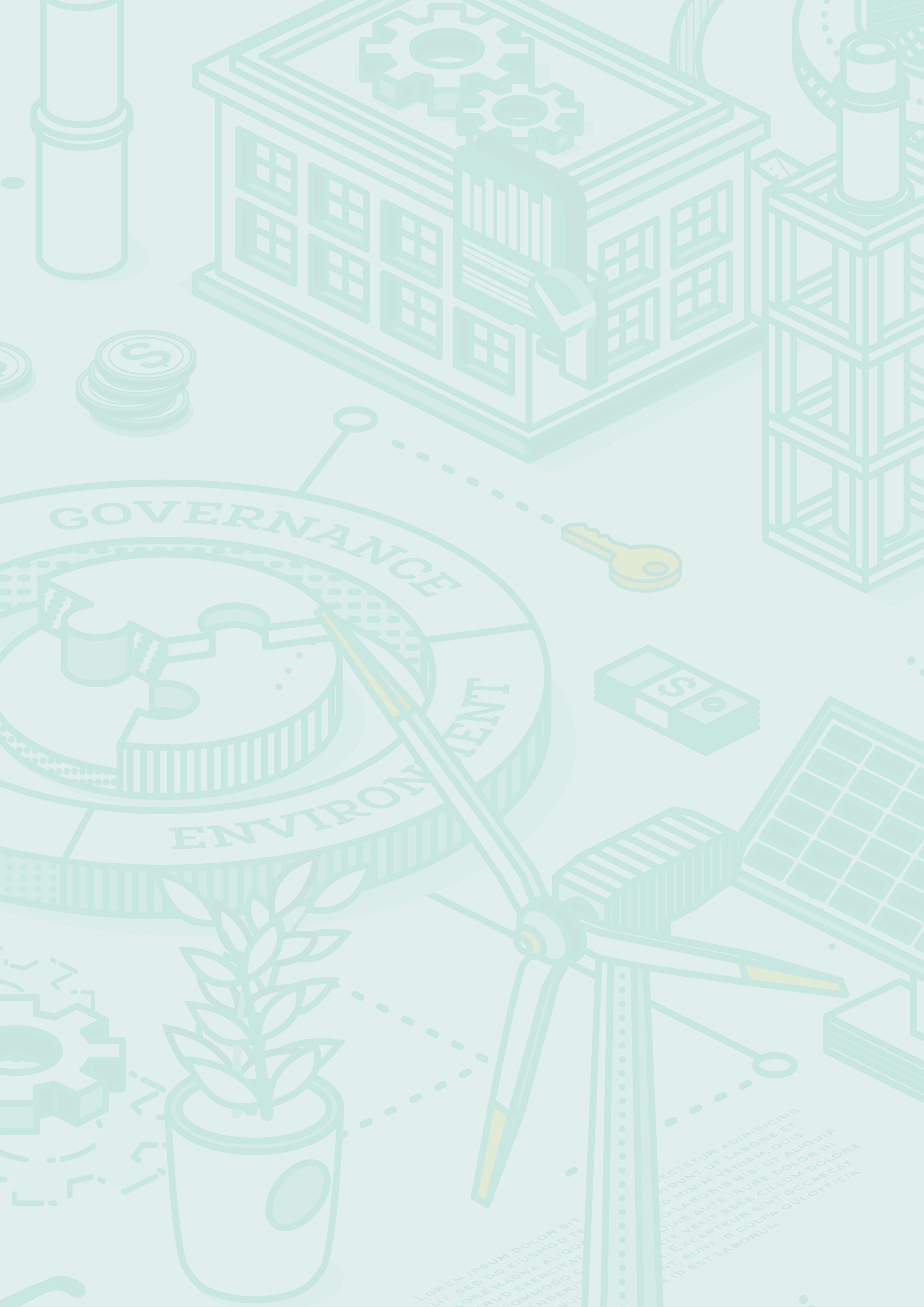
FORESIGHT

INTEGRATING ESG FACTORS INTO EXECUTIVE REMUNERATION

Professor Mak Yuen Teen, PhD, FCPA (Aust.)
NUS Business School | National University of Singapore


GOVERNANCE

INTEGRATING ESG FACTORS INTO EXECUTIVE REMUNERATION

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May 2022

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FOREWORD

Humanity often seems to forget that the Earth, with its finite resources, is shared by all of us. In pursuit of material prosperity and individual success, humankind has focused on the present, ignoring the future. However, there is increasing awareness that we cannot continue to borrow from future generations and will be forced to address its collective impact.

Global temperatures are currently 1.1 degrees Celsius above pre-industrial levels. Average annual global greenhouse gas emissions reached their highest levels in human history between 2010 to 2019. Although acknowledgement of the science that supports climate change has led to a reduction of the nearly 4 degrees Celsius by 2100 before Paris in 2014, we are still confronted with potential temperature rises of 3.2C by 2100. Even if all nations deliver on their respective pledges over the next decade, we are still heading towards an average increase of 2.8C, which is substantially above the 1.5C needed to avoid the most extreme of outcomes.

In order to succeed as the custodians of this planet we need to create a better and more equitable world. Our struggle to meet the 2030 target for the United Nations' Sustainable Development Goals, has been set back by the pandemic. The global poverty rate is projected to be 7% in 2030 and 2 billion people still lack safely managed drinking water. In Asia and the Pacific, none of the 17 Sustainability Development Goals (SDG) will be met by 2030, with widening disparities emerging as a result of Covid-19.

A growing awareness of sustainability issues coupled with an understanding about the importance and a sense of urgency is fuelling increased global action. These ambitions are however facing disagreements on the most appropriate approaches, a lack of resources, as well as plain scepticism or apathy.

Finance professionals and accountants have also historically had to navigate a myriad of sustainability related frameworks. The formation of the International Sustainability Standards Board (ISSB) has gone a long way to consolidate the reporting landscape and ease the confusion faced by preparers.

A 'whole of society' and 'whole of economy' approach that brings a range of stakeholders together to identify the issues, explore ideas and implement solutions is required. Capital allocation is fundamental to bring about the change we so desperately need. We will need to orient capital towards sustainability goals, and also to have the governance to help ensure that these goals are supported and met.

Academic efforts in the area of sustainability have produced a rich source of intellectual capital. However, there is still a gap in how research and learning is translated into policy and action. To this end, CPA Australia and the Sustainable Finance Institute Asia (SFIA) have come together to bring academic insights and ideas on sustainability in a way that they can be applied by corporates and the financial markets. This publication is the first in the CPA Australia - SFIA "*Foresight*" series. We hope that these publications will inspire the markets to leverage on academic insights and ideas while encouraging academia to continue the pursuit of knowledge that will help bring change to the markets.

We need to strike the balance of responsibility between providers of capital, such as investors and bankers, and managers of capital, such as management and directors. Unfortunately, there is often a disconnect between how these parties are incentivised to support and drive sustainability with either vague or incorrect signals being sent to them. This important issue forms the topic of the first *Foresight* paper. We would like to thank Professor Mak Yuen Teen for authoring this paper which we hope will encourage reflection, provide a platform for discussion and spur action for stakeholders, as well as Karys Lam and Vidhi Killa for their research assistance in the preparation of this report.

Max Loh FCPA (Aust.)
Divisional President – Singapore
CPA Australia

Eugene Wong FCPA (Aust.)
Chief Executive Officer
Sustainable Finance Institute Asia

May 2022

EXECUTIVE SUMMARY

With the growing interest in environmental, social and governance (ESG) issues among companies, investors and regulators, there has been increasing calls to link ESG to executive remuneration - if ESG factors are important, then linking them to executive remuneration should help ensure that executives pay attention to them. However, there is skepticism about doing this, with concerns revolving around the subjectivity of the ESG metrics used and possible abuse. In contrast, using quantifiable ESG metrics may reduce the risk of abuse, but what is quantifiable may not necessarily capture the most critical factors, and result in other important ESG being ignored. Although linking ESG metrics to executive pay can be useful, this may also be counter-productive if not done well and end up boosting executive pay or shielding them from poor performance. As such, companies seeking to link ESG to remuneration policies should ensure that ESG integration is done hand-in-hand with the strategies, policies and practices of the business.

Choice of ESG Factors and Metrics (Pg 13)

Quantitative metrics are more objective and observable but may be narrow and not reflect the most material ESG factors for a company, and targets set may be easily achievable with minimum effort from management. Qualitative goals and metrics may be necessary for ESG factors that are multi-dimensional or difficult to quantify. The process of selecting the appropriate ESG factors and metrics should start from a robust materiality assessment of the ESG factors which are most important to the company and industry.

Methods of incorporating ESG factors into compensation plans (Pg 19)

There are different approaches that companies can use to incorporate ESG metrics into executive remuneration. A weighted approach is to have ESG as a key performance indicator (KPI) that is directly part of the payout formula. Alternatively, a "modifier" or "multiplier" approach allows modifications that is built into the payout formula upfront, based on certain ESG metrics or an ESG scorecard, to the incentive payout. The "underpin" approach (also called "hurdle", "trigger" or "tripwire") provides a threshold or basic level of performance that is required for some or all of the payout under other metrics to be made, but is less used.

Weighting of ESG metrics (Pg 22)

If ESG is important enough for a company to incorporate into remuneration, then the weighting should be sufficiently meaningful to influence behaviour. Companies that are starting on the journey to link ESG factors to remuneration may consider using the lower end of the weighting, and gradually increasing the weighting as more quantitative and measurable ESG metrics are developed. Surveys show that weightings of 5% to 25% for ESG metrics are relatively common globally for companies that incorporate such metrics in their plans, but these metrics may not necessarily be explicit or non-discretionary in nature.

Short term vs Long term incentives (Pg 24)

In general, companies should have both short term incentives (STIs) and long term incentives (LTIs) in place – LTIs are necessary to motivate executives to take a long-term view, while STIs are necessary to recognise executives' progress in meeting annual goals that are aligned to long-term value creation and success. The balance between STIs and LTIs will depend on factors such as the business and the ownership of the company.

Internal targets vs external benchmarks (Pg 27)

Most international companies that are relatively advanced in incorporating ESG factors into executive remuneration appear to use mostly internal targets, as they can better reflect the company's context and may be more suitable. While external comparisons against peers and ESG ratings can increase objectivity and provide a more comprehensive basis for performance assessment, choosing appropriate peers and obtaining comparable information may be challenging. The lack of consistency among external ESG ratings, on the other hand, limit their usefulness as a major basis for assessing ESG performance.

Balancing objectivity and discretion (Pg 29)

It is unlikely that purely objective measures will adequately capture all the material ESG issues. Therefore, some subjective measures and the exercise of judgement by the remuneration committee and board will likely be necessary. Whether objective metrics, subjective performance evaluations or a combination of both are used, the key is good remuneration governance, transparency, and engagement with stakeholders.

ESG-linked remuneration practices in ASEAN (Pg 31)

Most ASEAN companies are just starting the process in incorporating ESG factors into executive remuneration, and there are many issues to consider as they embark on this journey. As seen in other international markets, institutional investors are increasingly expecting companies to incorporate ESG factors into executive remuneration, while demanding more transparency on how it is done. In addition, disclosure requirements, such as seen in the International Sustainability Standards Board's recently released *Exposure Drafts on the General Requirements for Disclosure of Sustainability-Related Financial Information* will mean ASEAN companies have to ensure that their disclosures allow investors to understand the linkage between ESG factors and executive remunerations.

INTEGRATING ESG FACTORS INTO EXECUTIVE REMUNERATION

10 Questions for Remuneration Committees and Boards of Directors

1. Should the company link ESG factors to executive remuneration?
2. What specific ESG factors should be considered?
3. What specific ESG metrics should be defined relative to each factor?
4. Should quantitative or qualitative metrics be used?
5. Should ESG metrics be stand-alone, part of an ESG scorecard, or part of an overall scorecard?
6. Should ESG performance directly determine remuneration, modify payouts otherwise earned, or be a precondition for payouts?
7. How much should ESG metrics be weighted?
8. Should ESG metrics be incorporated into short-term incentives (STIs), long-term incentives (LTIs) or both?
9. Should ESG performance be measured against pre-set internal targets or external benchmarks?
10. How can the remuneration committee balance objectivity and judgment when evaluating ESG performance in determining executive remuneration?

INTRODUCTION

Within three days in February 2022, the Financial Times ("FT") ran three articles with the following headlines:

"US companies add environmental and social targets to executive bonuses" (FT, 20 February 2022)[1]

"AllianzGI to vote against European companies that fail to link pay to ESG" (FT, 22 February 2022)[2]

"UK water companies told to link executive pay to performance…Regulator Ofwat expects remuneration to reflect measures such as sewage pollution" (FT, 22 February 2022).[3]

The growing interest in environmental, social and governance (ESG) issues among companies, investors and regulators has led to increasing calls to link ESG to executive remuneration. Including ESG factors in incentive plans has been called one of the most significant changes in executive remuneration in over a decade.[4]

The logic appears compelling. If ESG factors are important, linking ESG factors to executive remuneration should help ensure that executives pay attention to these factors. However, there is skepticism about doing this, even among investors who believe that ESG is important.

As one of the FT articles pointed out:[5]

"As bonuses tied to environmental, social and governance (ESG) issues increase, shareholders are sceptical…ESG pay provisions tend to be vague, and asset managers expressed concerns that if ESG pay replaces bonus targets tied to share price performance, then executives could be insulating bonuses…ESG metrics in pay 'are either incredibly broad and high level and almost always – at least in the US – coming into the short-term [pay] programme'."

The same article quoted a remuneration consultant who said:

"Companies should move toward quantifiable ESG-pay metrics, such as the specifics Starbucks adopted, said Robin Ferracone, founder of Farient Advisors, a pay consultancy. Companies should be 'afraid of the blowback' if they pay bonuses derived from imprecise ESG metrics, she said."

These quotes sum up the dilemma faced in linking ESG factors to remuneration. While investors and regulators are increasingly expecting companies to do so, there are also concerns about the subjectivity of ESG metrics and possible abuse. Using quantifiable ESG metrics can reduce the risk of abuse, but what are quantifiable may not necessarily capture the most critical ESG factors for a company.

Consider the case of Starbucks. In 2021, the company failed to win investor support for its executive bonuses for the previous year, in part because of a US$50 million retention bonus offered to its CEO. Starbucks then revamped its bonus packages and added new environmental and human-rights criteria. Ten percent of the CEO's annual bonus was tied to environmental provisions, such as those relating to efforts to "eliminate plastic straws" and "farm-level methane reduction". A further 10% was tied to retaining minority workers, and other workplace goals.

Following the changes, the CEO achieved all his bonus targets and his total pay increased from US$14.7 million in 2020 to US$20.4 million in 2021 - after it had fallen in 2020 from US$19.2 million in 2019.

Were the ESG metrics for the CEO the only, or even the most important, metrics that matter for Starbucks? How were the targets set? Were they sufficiently stretched? How was achievement of the targets assessed, especially for those that are qualitative in nature?

These are just some of the questions that arise when ESG factors are used to determine executive remuneration.

Ironically, just a month after the FT article, Starbucks announced that their CEO will be retiring in April. His departure came after Starbucks employees voted at the end of last year to form their first union in the US. Starbucks was accused of "union busting" and faced a federal labour charge filed by workers, who claimed that the company was involved in illegal activity such as engaging in threats, intimidation and surveillance related to the attempt to form a union.

Did the "social" factors included as key performance indicators (KPIs) in the CEO's bonus plan adequately factor in employee relations and was the assessment of his performance on the "social" aspects fair? After all, he did achieve all his bonus targets, including the ESG ones, and his pay increased substantially.

Objectives of this report

Research by the Principles for Responsible Investment covering 84 extractive and utility companies included in major stock indices in North America, Europe and Australia, identified 15 indicators on ESG and pay practices.[6] The issues covered in this report are partly based on these indicators.

One of the major objectives of this report is to summarise research, including academic research, on the issue of linking ESG factors to executive remuneration, and their practical implications.

The report will also provide an assessment of whether and how major ASEAN listed companies are incorporating ESG factors into executive remuneration.

Caveats

Some words of caution are in order about the academic research studies covered in this report. First, even though they are published in highly reputable journals and undertaken by reputable scholars from some of the best universities, research findings are rarely conclusive. The research findings should be viewed as current thinking on the subject among academics, which could change over time as further studies are conducted.

Second, while these studies use sophisticated econometric methods to attempt to rule out spurious relationships and reverse causality, the studies are not conducted in laboratory-like settings which means other explanations cannot be discounted.

Third, while relationships found may be statistically significant, they may not be economically significant, and factors that are studied may only explain a small part of the phenomenon.

Nevertheless, the academic research findings can be a useful source of current thinking on this important subject.

SHOULD ESG ISSUES BE LINKED TO EXECUTIVE REMUNERATION?

IN A NUTSHELL

Should the company link ESG factors to executive remuneration?

Although linking ESG metrics to executive pay can be useful, it may be counter-productive if not done well. Some key issues companies should consider include:

- Are there specific material ESG risks for the company?
- Can meaningful metrics be used to capture these risks?
- Can measurable targets be set for these metrics?

Linking ESG to remuneration policies should go hand-in-hand with ESG integration into the business, which includes incorporating ESG factors into strategies, policies and practices (such as those relating to employees, customers and environment).

A 2020 report found that more than 50% of companies in the ASX 100 in Australia; S&P 100 and TSX 60 in North America; CAC 40, DAX 30 and SMI 20 in Europe; FTSE 100 in UK and STI 30 in Singapore, used ESG measures in their incentive plans (Figure 1).[7]

Many other surveys report similar trends. However, there is no clear definition or consistency across studies of what are considered ESG measures – especially those relating to the "social" and "governance" aspects.

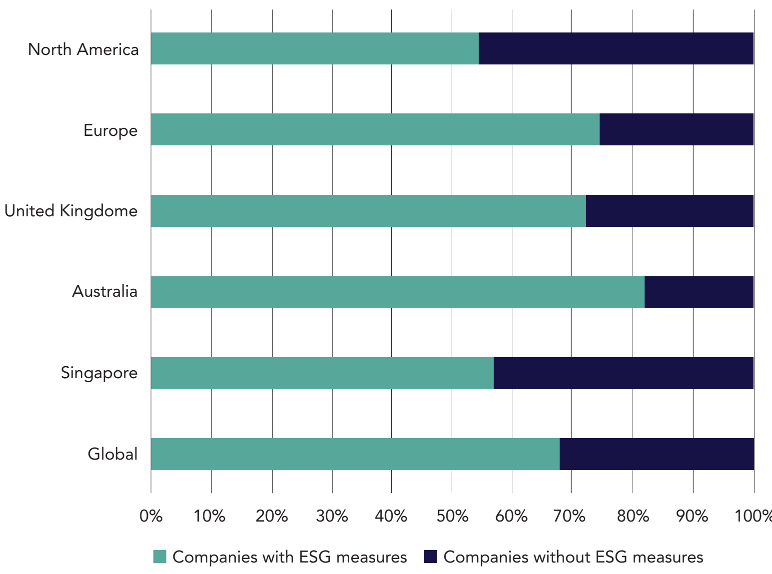

Figure 1: Use of ESG Measures in Incentive Plans (Source: Guerdon Associates and GECN Group Research)

UK and EU companies have been found to be faster in including ESG metrics in incentive plans than US companies. According to a June 2021 report, 45% of UK FTSE 100 companies have linked executive pay to ESG metrics. Those that are likely to be willing or have already adopted ESG measures are industry leaders in Energy, followed by Utilities and then Real Estate.[8] One-in-four companies have added ESG metrics to long-term incentive packages.

Another study based on annual reports of UK FTSE 250 companies published up to the end of March 2021 found that the percentage using ESG measures in annual bonuses had increased to 30%, up from 19% the previous year.[9]

A Deloitte review[10] of proxy statements filed by Fortune 100 companies in the US between February 2020 and January 2021 found that less than 40% have incorporated ESG measures in their executive incentive plans.

According to proxy advisory firm Glass Lewis & Co, a quarter of U.S. companies in 2021 included some form of environmental or social metric as part of their executive incentive plans, up from 16% in 2019.[11]

It is expected the US will close the gap with UK and Europe quickly.[12] The Securities and Exchange Commission (SEC) is working on "pay-versus-performance" rules that would require companies to disclose links between executive pay and their financial results. It is considering allowing companies to include ESG metrics if they are tied to executive compensation.[13]

Academic insights

Some recent academic studies show that linking ESG metrics to executive pay leads to improvement in various outcomes. Most of these studies used the older term "corporate social responsibility" (CSR) rather than ESG.

One of the first academic studies on this subject was by Hong, Li and Minor (2016).[14] Based on public filings by US S&P 500 companies, they found that companies with more shareholder-friendly corporate governance are more likely to provide compensation to executives that is linked to CSR outcomes. Further, providing executives with direct incentives for CSR is effective for increasing CSR performance.

Flammer, Hong and Minor (2019) studied the integration of corporate social responsibility (CSR) criteria in executive compensation ("CSR contracting") for all S&P 500 companies in the US over a 10-year period from 2004 to 2013.[15] They found that CSR contracting has become more prevalent over time. The adoption of CSR contracting was found to lead to (a) an increase in long-term orientation; (b) an increase in firm value; (c) an increase in social and environmental initiatives; (d) a reduction in emissions; and (e) an increase in green innovations.

One question that often arises is the credibility of CSR disclosures and how to enhance it. A 2020 unpublished working paper by Grabner, Renders and Yang based on S&P 500 companies in the US examined the role of CSR contracting in enhancing the credibility of CSR disclosures.[16] They found that CSR disclosures and CSR contracting, when used together, improved CSR performance, and more so when CSR disclosures included the impact of the CSR activities and there was more intensive use of CSR contracting. Intensity of CSR contracting was measured in two ways: the scope of CSR performance measures and the relative importance of CSR versus non-CSR performance measures. They also found that CSR contracting improves the credibility of CSR disclosures even if there was external assurance for a CSR report.

Companies that were under high public scrutiny, measured by presence of reported controversies in the media and affiliation to industries that were often accused of greenwashing activities, were found to be more likely to use both CSR disclosures and CSR contracting to overcome credibility concerns.

Using a large sample of companies from 30 markets, a study by Tsang, Wang, Liu and Yu (2021) found that CSR contracting was associated with greater innovation output.[17] The positive association was stronger in countries with weak stakeholder orientation, with weak legal environments, and without mandatory CSR reporting requirements. In other words, incorporating CSR into executive compensation can help mitigate weaknesses in regulations and stakeholder focus in a country.

The study further explored how CSR contracting promoted innovation. A key finding was that CSR contracting had a strong effect on innovation for companies with low CSR performance related to employees, measured by employee well-being and its four dimensions of employment quality, workplace health and safety, training and development, and diversity and opportunity. This suggests that including CSR metrics into executive pay is especially beneficial for companies which have low CSR performance. The authors argue that CSR contracting can encourage greater future-oriented CSR engagement by signalling companies' substantive commitment to CSR engagement, thereby attracting and retaining talented employees and incentivising them to innovate. Consistent with this, CSR contracting was found to improve all five measures of employee well-being one year later. CSR contracting also consistently increased employee innovation productivity.

Another way that CSR contracting improved innovation was by encouraging managerial risk-taking and reducing managerial short-termism, which the use of traditional financial measures may foster. Finally, they found that CSR contracting led companies to allocate expenditure on research and development more efficiently, improving innovation.

Contrary views about linking remuneration to ESG metrics

Not all academics agree that linking ESG metrics to executive remuneration is a good idea. Some raise concerns that ESG metrics used in executive remuneration contracts may not be the most important. Companies may choose those ESG factors that are easily measurable but may not capture the most important ESG issues for a company. This could result in other important ESG issues being ignored. ESG metrics may also be used to boost executive pay or shield executives from poor performance.

An example which was cited is Marathon Petroleum in the US, which awarded its CEO a US$272,000 bonus for exceeding environmental goals in the same year when the company spilled 1,400 barrels of fuel in an Indiana creek - its worst oil spill in years. The performance of Marathon's top executives was assessed on number of significant oil spills in a year, not the total volume, and the Indiana spill counted as just one of 23 incidents in 2018.[18]

At its shareholders' meeting held in May 2021, 70% of the shares voted opposed the company's "Say-on-Pay" resolution, the largest margin so far that year at an S&P 500 company.[19]

As Tom Gosling, an executive fellow of the Centre for Corporate Governance at the London Business School said: "That's a classic example of what I call hitting the target but missing the point." [20]

Gosling questioned whether linking ESG performance targets to executive pay will actually change executives' behaviour. As the CEO is responsible for setting strategy, ESG targets may simply reflect what the company was already planning to do anyway. While this does not mean the practice has no value, he said: "Doing this stuff badly is almost worse than not doing it at all." [21]

Professor Alex Edmans, a professor of finance at the London Business School said:

"These unintended consequences [of linking CEO pay to ESG metrics] might be even worse for ESG than financial targets. One challenge is that, for financial performance, only a couple of measures might be relevant. But ESG performance is multifaceted. Companies have a responsibility to many stakeholders – employees, customers, suppliers, the environment, communities and taxpayers – and for each stakeholder, many dimensions are relevant. Either the contract includes only a couple of ESG measures and the CEO ignores others, or it includes most of them and the contract becomes so complex that it loses any motivational effect….A second problem is measurement. For a financial target such as earnings-per-share, there's consensus on how to measure it. But that isn't the case for an ESG metric."[22]

The exceptions, according to him, are companies where one or a few ESG issues are much more important, such as decarbonisation for an energy company.

One of the fiercest critics of linking ESG metrics to remuneration is Professor Lucian Bebchuk of Harvard Law School. In a recent working paper with his fellow colleague, Professor Roberto Tallarita, they argued that the use of ESG-based compensation has at best a questionable promise and poses significant risks.[23] Based partly on an empirical analysis of the use of ESG compensation metrics in US S&P 100 companies, they identified two structural problems. First, ESG metrics commonly attempt to tie CEO pay to limited dimensions of the welfare of a limited subset of stakeholders. Therefore, even if these pay arrangements were to provide a meaningful incentive to improve the given dimensions, the use of these metrics could well ultimately hurt, not serve, aggregate stakeholder welfare.

Second, ESG metrics exacerbate the agency problem of executive pay and may undermine the progress in making executive pay more transparent, more sensitive to actual performance, and more open to oversight and scrutiny. Most companies that disclose the use of ESG goals do not disclose relevant targets and actual outcomes, or leave significant discretion to their boards. Their empirical analysis shows that in almost all cases in which S&P 100 companies use ESG metrics, it is difficult if not impossible for outside observers to assess whether they provide valuable incentives or rather increases CEO pay through performance-insensitive pay.

They argued that current use of ESG metrics likely serves the interests of executives, not of stakeholders, and that expansion of ESG metrics should not be supported even by those who care deeply about stakeholder welfare.

CHOICE OF ESG FACTORS AND METRICS

IN A NUTSHELL

What specific ESG factors should be considered? What specific ESG metrics should be defined relative to each factor?

There are many ESG factors and metrics that companies can link to remuneration. Different aspects of ESG are important to different sectors and companies.

Key considerations in choice of ESG factors and metrics are:

- The process of selecting the appropriate ESG factors and metrics should start from a robust materiality assessment of ESG factors which are most important to the company and industry. These ESG factors should also underpin the preparation of the sustainability report and be integrated into the company's long-term strategies.
- Avoid letting the choice of ESG metrics be driven mainly by regulation and measurability. For example, while climate risk and diversity/inclusion are clearly important for most companies, regulatory focus on these areas may lead companies to only link remuneration to metrics in these areas, to the exclusion of other material ESG factors.
- Remuneration committees and boards should be mindful of this axiom: "You get what you measure but not necessarily what you want".

The Principles for Responsible Investment (PRI), which has over 4,700 signatories comprising pension funds, insurers, investment managers and service providers, said in a recent consultation response to the US SEC that investors need ESG metrics which are "comprehensive, reliable, and consistent".[24] Companies should not reward executives for "business as usual", such as compliance with environmental laws or simply improving perceptions about sustainability or other ESG goals.

A report by PwC and the Centre for Corporate Governance of the London Business School on UK FTSE100 companies found that, overall, social measures are most commonly linked to executive pay, followed by environmental measures and then governance measures. [25] This is based on public disclosures released by these companies in 2020.

% of companies	ESG	E	S	G
Bonus	37	10	32	11
LTIP	19	11	8	7
Overall (Bonus or LTIP)	45	18	37	16

The table below summaries the types of measure we have classified under E, S and G

Environmental	Social	Goverance
• Decarbonisation • Energy Reduction • General Environmental • Plastic Reduction • Water Usage	• Diversity & Inclusion • Employee Engagement • Safety • Societal / Communities	• Strengthening or remediating governance • Risk

Figure 2: Use of ESG Measures by UK FTSE 100 Companies (Source: PwC and London Business School)

The use of ESG measures was found to be far more common in annual bonuses than long-term incentives (LTIs). There is also a difference in the type of ESG measure used for the annual bonus and LTIs. For the annual bonus, social measures were four times more commonly used than environmental measures, while environmental measures were slightly more commonly used than social measures for LTIs.

Figure 2 shows the usage of ESG measures across different incentive plans and some of the common measures used by FTSE100 companies based on their study. In a later part of the report, we will examine more closely the use of ESG measures in annual bonuses – or STIs – and LTIs.

ISS Corporate Solutions found that while social metrics are more common in companies in UK and Ireland, environmental measures are seeing faster adoption in European companies. Environmental measures are also taking an increasing share of ESG metrics in all these countries, particularly in LTIs.[26]

A Deloitte review[27] of proxy statements filed by Fortune 100 companies in the US between February 2020 and January 2021 found that less than 40% have incorporated ESG measures in their executive incentive plans. Of those companies that have used ESG measures in their annual incentive plan, the most common ESG measures fall under the "social" category, followed by "environmental".

Additionally, Deloitte's review found that measures tied to human capital/culture and diversity, equity, and inclusion are by far the most common type of measures found in annual incentive plans.

Figure 3 shows some sample ESG measures that they found in executive incentive plans.

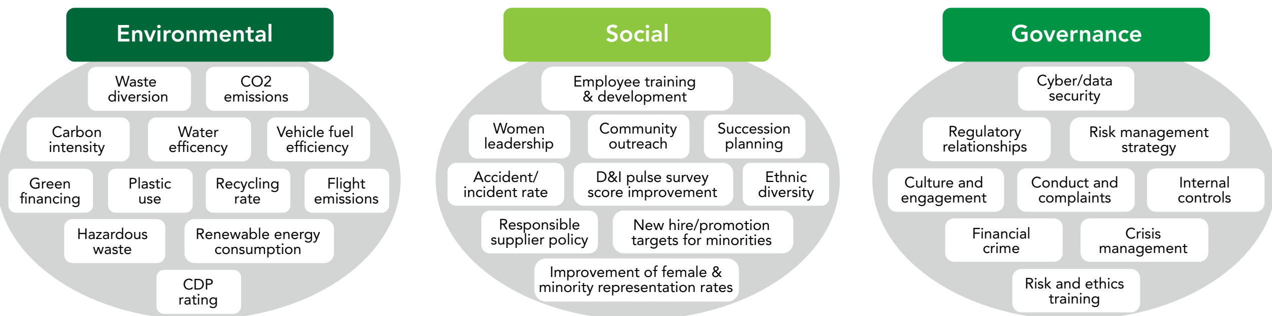

Figure 3: Examples of ESG Measures in Executive Incentive Plans (Source: Deloitte)

Pay Governance reported that UK and EU companies were well ahead of US companies in including ESG metrics in incentive plans, based on a comparison of 95 US companies and 30 companies from the major stock indices in the UK and EU.[28] There were also differences in the type of ESG measures used by US companies compared to UK/EU companies, with 44%, 84% and 40% of the former using environmental, social and governance measures respectively, compared to 89%, 100% and 11% for UK/EU companies. Table 1 shows selected environmental and social metrics used by these companies.[29]

Environmental Measures	Social Measures
Energy efficiency/Renewable energy	Diversity
Carbon emissions/Greenhouse gas	Human Capital
Compliance with applicable laws	Inclusion and Belonging
Emissions / Containment	Community Impact
Waste reduction/Sustainable sourcing / PET reduction	Employee Safety
Environmental stewardship	
Sustainability	

Table 1: Selected Environmental and Social Measures Used in 2020 Incentive Plans by UK/EU and US Companies (Source: Pay Governance)

Table 2 shows the ESG metrics under WillisTowersWatson ESG metric classification.[30]

Environmental Metrics	Social Metrics	Governance Metrics
Waste reduction	Gender balance	Human and labour rights along supply chain
Reduce carbon intensity	Female representation	Participation in sustainability index
Reduce number of environmental incidents	Inclusion & diversity	Corporate social responsibility
Environment & sustainability	Employee health & safety	Stakeholder engagement
Energy reduction	Employee engagement	
Reduce greenhouse gas emission	People & HR	
	Talent retention	
	Lost time incident frequency rate	
	Managerial skills	
	Customer service	
	Customer satisfaction	
	Net promoter score	
	Food safety incident rate	

Table 2: Environmental, Social and Governance Metrics Used by Companies (Source: WillisTowersWatson)

Based on the surveys cited above, there is more consensus as to what are considered environmental factors and appropriate measures and metrics, compared to social and governance factors.

A survey of use of ESG metrics in US companies found that the percentage of companies that use just a single objective in their incentive plans declined from 36% in 2020 to 31% in 2021.[31] Given that companies generally have to consider the interests of many different stakeholders, it is unlikely that a single objective will be appropriate. That being said, companies also have to recognise that having too many metrics will likely be counter-productive.

QUANTITATIVE VERSUS QUALITATIVE METRICS

IN A NUTSHELL

Should quantitative or qualitative metrics be used?

Quantitative metrics are often preferred by investors but such metrics also have limitations. They may be too narrow and may not adequately capture the material ESG issues important to the company.

Some key considerations for companies are:

- Where quantitative metrics are used, they should consider disclosing specific targets at least after the end of the performance period and explain how they are set.
- Targets that are set should provide sufficient “stretch”.
- If qualitative metrics are used, it is particularly important for companies to explain how performance against these metrics is assessed.

Quantitative metrics are more objective and observable. However, they may not reflect the most material ESG factors for a company and are often narrow. Further, even if quantitative metrics are used, targets that are set may be easily achievable with minimum effort by management.

Qualitative goals or metrics may be necessary for ESG factors that are multi-dimensional or difficult to quantify.

A recent survey found that 56% of UK/EU companies used a combination of quantitative and qualitative ESG metrics in their 2020 incentive plans, while 26% used only qualitative metrics, with only 19% using only quantitative metrics.[32] For US companies, 52% used a combination of quantitative and qualitative measures, 24% used only qualitative measures and 24% used only quantitative measures.

A survey by ISS Governance reported that investors prefer objective metrics, as shown in Figure 4.[33] While 86% of investors felt it useful to incorporate ESG metrics in executive compensation programs, 52% said they should only be used if they are “specific and measurable” and “their associated targets are communicated to the market transparently”. In contrast, non-investors (which include public corporations, board members of public corporations, advisors to public corporations and other non-investors) are more open to the ESG metrics that are less measurable.

Do you believe incorporating non-financial Environmental, Social, and/or Governance-related metrics into executive compensation programs is an appropriate way to incentivise executives? Please select the answer below that most closely reflects your view.

	Investors	Non-investor
No, non-financial ESG performance metrics are not usually relevant or effective as compensation program measures. Compensation programs should only use traditional financial performance measures, for transparency and to maintain alignment with shareholders’ financial interests.	4%	16%
Yes, but such metrics should only be used in compensation programs if the metrics selected are specific and measurable, and their associated targets are communicated to the market transparently.	52%	27%
Yes, when chosen well, even ESG-related metrics that are not financially measurable can be an effective way to incentivise positive outcomes that be important for a company	34%	46%
Other	10%	10%
Total number of respondents	**157**	**241**

Figure 4: ESG Metrics in Executive Compensation (Source: ISS Governance)

Given investors' preference for "specific and measurable" metrics, it is likely that the use of quantitative metrics will increase.

Academic insights

Ikram, Li and Minor (2019) sought to understand why companies offer CSR-contingent compensation and the conditions under which such compensation improves social performance[34]. The CSR categories they studied were safety, health and environment; customer satisfaction; employee satisfaction; diversity; corporate citizenship/responsibility and sustainability; and ethics/corporate culture. Using proxy statements of all S&P 500 companies in the US at the end of 2013, they found that CSR contracting varied significantly across industries and across different CSR categories.

Well-governed companies were more likely to offer CSR-contingent compensation, which resulted in higher corporate social standing. Such companies were more likely to offer formula-based, objective CSR-contingent compensation.

However, non-formulaic, subjective CSR-contingent compensation also helps improve companies' social performance when company outcomes are more volatile and unpredictable, and therefore executives' effort and performance are harder to evaluate, and when firms have better corporate governance. This suggests that in situations where it may be difficult to set objective ESG metrics and accurately assess ESG performance, subjective ESG metrics are also beneficial for better governed companies.

In a recent unpublished paper, Li, Wang and Zhao (2021) examined executive compensation contracts that are explicitly linked to corporate social performance[35]. CSR contracts that were studied linked executive compensation to community, diversity, employee, environment, human rights and product, and/or other variables related to CSR such as ethical conduct.

They studied two types of CSR contracts – objective CSR contracts that provides the executive with a specific goal and determined reward, and subjective CSR contracts where only general performance conditions are specified and the amount of reward linked to performance is unknown before the end of the performance period.

Their first finding is that companies with objective contracts had a higher CSR rating than those with subjective contracts. Further, the most appropriate CSR-related variable was different for objective contracts and subjective contracts. For objective contracts, ethical conduct had the strongest relationship with the CSR rating, while social responsibility improved CSR rating the most for subjective contracts. In other words, whether objective or subjective contracts are appropriate depends on the ESG factor to be linked to remuneration.

METHODS OF INCORPORATING ESG FACTORS INTO INCENTIVE PLANS

IN A NUTSHELL

Should ESG metrics be stand-alone, part of an ESG scorecard, or part of an overall scorecard? Should ESG performance directly determine remuneration, modify payouts otherwise earned, or be a precondition for payouts?

There are different ways that companies can incorporate ESG factors in incentive plans.

Some key considerations:

- While stand-alone ESG metrics are the most objective and have the clearest link to remuneration, they are likely to be most suitable for companies with a small number of material ESG factors that are critical to the company and industry. For other companies, a separate ESG scorecard with an overall weighting and specific ESG metrics can be considered.
- A "modifier" approach may be considered by companies that prefer to have the ability to adjust the payout upwards or downwards based on ESG KPIs being achieved or not achieved. However, upward adjustments in particular need to be clearly explained, as they may be seen to be inflating the remuneration of the executive.

There are different approaches that companies can use to incorporate ESG metrics into executive remuneration. A report by WillisTowersWatson provides a conceptual view of these approaches, as shown in Figure 5.[36]

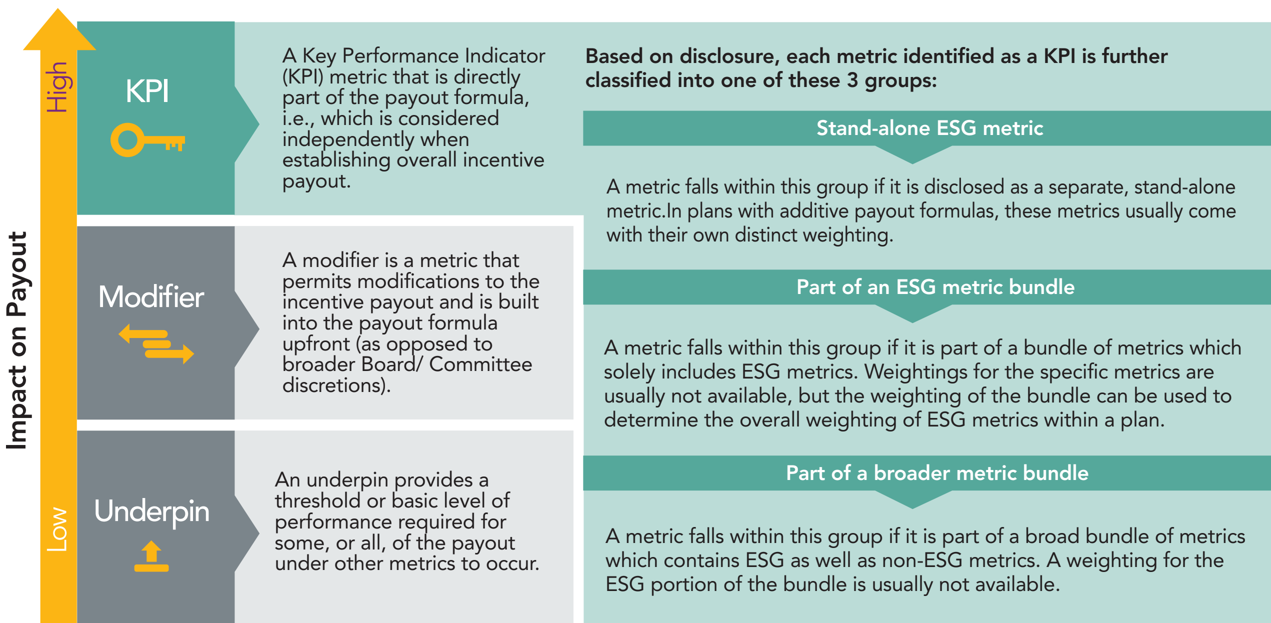

Figure 5: Approaches for incorporating ESG into incentive plans (Source: WillisTowersWatson)

Weighted approaches: Stand-alone metrics versus scorecard

A weighted approach is to have ESG as a key performance indicator (KPI) that is directly part of the payout formula. This can be implemented in one of three main ways:

- stand-alone ESG metrics which are individually weighted (sometimes also called measured metrics or weighted components)
- part of an ESG metric scorecard that is collectively weighted but not individually weighted
- part of a broader scorecard which includes ESG and non-ESG metrics (e.g., a "balanced scorecard" that includes financial, operational, customer, ESG and other metrics)

How BP, Chevron and Danone, S.A. Link ESG Factors to Executive Remuneration

Under the terms of **BP's** 2020 remuneration policy, two ESG measures for safety and sustainability, each weighted 15%, are used. Safety is measured by process safety tier 1 and tier 2 events. Sustainability is measured by sustainable emissions reductions (in million tonnes). For each metric, threshold, target, maximum and the actual outcome are disclosed.

The above are part of a formula to determine the annual bonus of the executive directors – the CEO and CFO – and the formula also includes operational performance (20% weighting) and financial performance (50% weighting). The overall formulaic score out of the maximum score is disclosed. The 2021 annual bonus scorecard based on the formula was 1.61 out of 2.0, or 80.5% of the maximum. The remuneration committee concluded that there were no reasons to adjust this outcome.

BP also has two LTIs, the group share value plan (GSVP) for senior leaders and the executive director incentive plan (EDIP), which are both performance share plans. Vesting for both plans is assessed using the same group performance scorecard and the formulaic outcome can then be adjusted on a discretionary basis by the board remuneration committee (for executive directors) or the CEO (for senior leaders).

The scorecard has three measures – relative total shareholder return (50% weighting), return on average capital employed (20%) and strategic progress (30%). Strategic progress comprises four equally-weighted measures, including ESG considerations, and they are: growing gas and advantaged oil in the upstream; market-led growth in the downstream; venturing and low carbon across multiple fronts; and gas power and renewables trading and marketing growth.

For **Chevron Corporation**, the corporate performance measures used for its 2020 annual incentive plan include an ESG category "health, environmental, and safety" which has an overall weighting of 15%, as part of a scoreard. Individual ESG performance measures are personal safety, process safety and environmental, and greenhouse gas management. There is no weighting disclosed for each of these performance measures. The company disclosed the assessment of year-end results versus the board-approved Business Plan, but does not disclose threshold, target, maximum and actual outcome like BP.

For personal safety, it was measured by total recordable incident rate and serious injury, and the company disclosed that total recordable injury rate led the industry, serious injury count was significantly better than plan, but there were gaps in fatality prevention. The overall result for personal safety was assessed to have "met Plan with some gaps" (coded yellow). For process safety and environmental, the results against plan stated that it was a "record low with zero Severe Tier 1 loss of containment ("LOC") incidents and "LOC and spill volumes better than Plan". The overall assessment was "exceeded Plan" (coded green). For greenhouse gas management, the assessment was "on track to achieve oil, gas, flaring, and methane intensity reductions" and "exceeded Plan" (coded green).

Investors seem to have a different view with regards to its performance relating to the environmental aspect as 61% voted in support of a shareholder climate resolution to reduce all of its emissions at its May 2021 AGM. Chevron subsequently modified the 2021 Chevron annual incentive plan scorecard, with operating performance changed to "operating and safety performance" and "health, environmental, and safety performance" changed to "energy transition". For the vesting of performance shares under its LTI plan, it added a second financial measure "relative ROCE improvement measured against the large-cap integrated energy companies". Chevron said it believed that both changes reinforce its objective of "higher returns, lower carbon" and are responsive to views expressed by its shareholders.

In the case of French company **Danone S.A**., the performance measures used to determine the annual variable remuneration include "social, societal and environmental", which comprises two metrics which are qualitative in nature – "employees sustainable engagement" and "fulfillment of climate ambitions". Each has a target weighting of 10%. Actual performance on each of these metrics can range from 0% to 20%, with overall actual performance including "economic" and "managerial" ranging from 0% to 200%.

In its 2021 compensation for the Chairman and Chief Executive Officer, Danone said that, following discussion, the board assessed performance of 100% for the social, societal and environmental component. This was based on the fact that the rate of employee engagement measured in the Danone People Survey in 2020 conducted by an outside firm was 91% (percentage of employees recommending Danone as a good place to work), which was 11 points higher than in the fast-moving consumer goods sector. It said that progress was also made in inclusive diversity, in particular the representation of women in senior and middle management positions, inclusive talent development and parental policy. The Bloomberg Gender-Equality Index has thus included Danone on its list of companies committed to supporting gender diversity.

In terms of environmental performance, it said that Danone was once again recognised as a leader in environmental performance, being awarded a "Triple A" score from CDP for the second year, making the A list in climate change, forests and water security. Danone's greenhouse gas emissions for scopes 1, 2 and 3 were also said to have fallen by a combined one million tonnes, of which approximately 50% was due to the company's regenerative agriculture actions.

The "managerial" category, based on organisational leadership, which was weighted 20%, was also assessed to be 100% fulfilled. In contrast, the "economic" category, which had a weighting of 60%, measured by growth, recurring operating margin and free cash flow, was assessed to be only 16.6% fulfilled.

In March 2021, Danone announced that its chairman and CEO would step down after a campaign to replace him by certain activist funds demanding economic performance. This was despite shareholders of Danone voting to turn it into an 'enterprise à mission', a category for companies in France similar to an American B-Corp, whose purpose was far broader than profits and growth, in June 2020 with the support of more than 99% of its shareholders at its Annual General Meeting.

According to Forbes: "[The chairman and CEO] will enter history as one of the leading executives promoting stakeholder capitalism and centering core business units around ESG (Environmental, Social, Governance) objectives. Yet his footprint and departure reveal a pervasive rift between staunch supporters of sustainable capitalism and hard-rugged corporate activists."[37]

"Modifier", "underpin" and discretionary approaches

A "modifier" or "multiplier" approach allows modifications to the incentive payout that is built into the payout formula upfront, based on certain ESG metrics or an ESG scorecard. This could increase or decrease the amount of payout that an executive is otherwise entitled to.

For example, in 2014, Unilever's then CEO received a £431,775 bonus for his work leading the company's sustainability plan, the Unilever Sustainable Living Plan (USLP).[38] The USLP includes targets for reducing greenhouse gas emissions, water and waste.

According to the company, he was awarded the "personal performance multiplier" after considering his "performance and leadership, including progress against the delivery of USLP goals and his overall contribution to making sustainable living commonplace". The CFO received a 10% addition to his bonus, taking the total to £746,130.

Unilever said the objectives also include cutting the company's environmental footprint in half by 2020 and sourcing all agricultural raw materials in a sustainable fashion.

Another example is Apple, which announced that in 2021, it was adding an ESG "bonus modifier" to its cash incentive program. Meeting ESG goals can increase the bonus by 10%, while failing to do so could cost a bonus reduction of the same amount.[39]

In contrast, an "underpin" approach (also called "hurdle", "trigger" or "tripwire")[40] provides a threshold or basic level of performance that is required for some or all of the payout under other metrics to be made.

A recent report found that 73% of UK/EU companies used weighted metrics, 14% used a "modifier" approach and another 14% used a discretionary approach. For US companies, 63% used weighted metrics, 8% used a "modifier" approach and 29% used a discretionary approach.[41]

Both stand-alone and scorecard approaches are widely used by companies across the different countries but the scorecard approach is more popular than the stand-alone metrics approach.[42,43] A Deloitte study of Fortune 100 companies found that the most common approach is by far the scorecard approach, followed by a modifier and stand-alone measure.[44]

A survey of US companies found that "underpins" are extremely rare, with only 1% using this for their STI plans and 0% using for LTI plans.[45]

WEIGHTING OF ESG METRICS

IN A NUTSHELL

How much should ESG metrics be weighted?

Surveys show that most companies that link ESG factors to remuneration have a weighting of between 5% and 25%.

Some key considerations for companies on weighting of ESG metrics are:

- If ESG is important enough for a company to incorporate into remuneration, then the weighting should be sufficiently meaningful to influence behaviour.
- Companies that are starting on the journey to link ESG factors to remuneration may consider using the lower end of weighting, and gradually increase the weighting as more quantitative and measurable ESG metrics are developed and used.

A 2019 report by Mercer[46] found that 36% of companies in Europe had a weighting of between 5% to 10% for ESG metrics in STIs, and another 26% had a weighting of 10% to 25% (Figure 6). For European companies that use ESG metrics in STIs, less than 5% weighting and more than 25% weighting were relatively rare.

For North American companies, there was more dispersion in weighting, with 33% having 5% or less, 24% having 5% to 10%, 22% having 10% to 25%, and 6% having more than 25%. For now, the weighting of ESG metrics for incentive plans of US companies was said to be expected to be typically less than 25%.[47]

How much do ESG metrics count in short-term incentive plans?

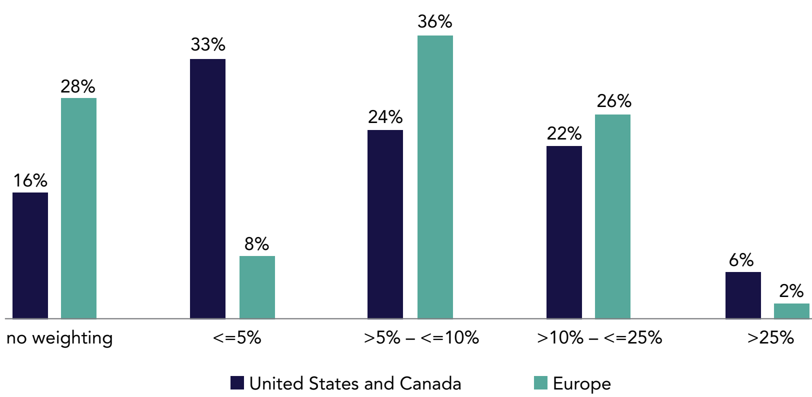

Figure 6: Weighting of ESG metrics in STIs (Source: Mercer)

For LTIs, 40% of European companies had a weighting of 10% to 25% and another 10% had a weighting of more than 25% (Figure 7). For North American companies, one-third had 5% to 10% weighting and 17% had more than 25% weighting.

Where are companies in long-term incentives integration?

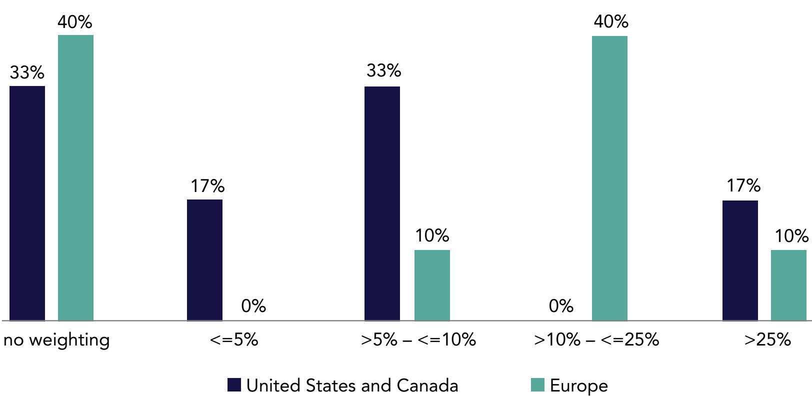

Figure 7: Weighting of ESG metrics in LTIs (Source: Mercer)

A study of UK FTSE 100 companies found that, where ESG metrics are used in incentive plans, environmental metrics have higher average weighting in LTIs compared to social and governance metrics (Figure 8).[48] In contrast, for STIs, governance metrics, followed by social metrics, have higher weighting than environmental metrics. Overall, ESG metrics have marginally higher weighting in LTIs compared to STIs, for companies that include them in these plans.

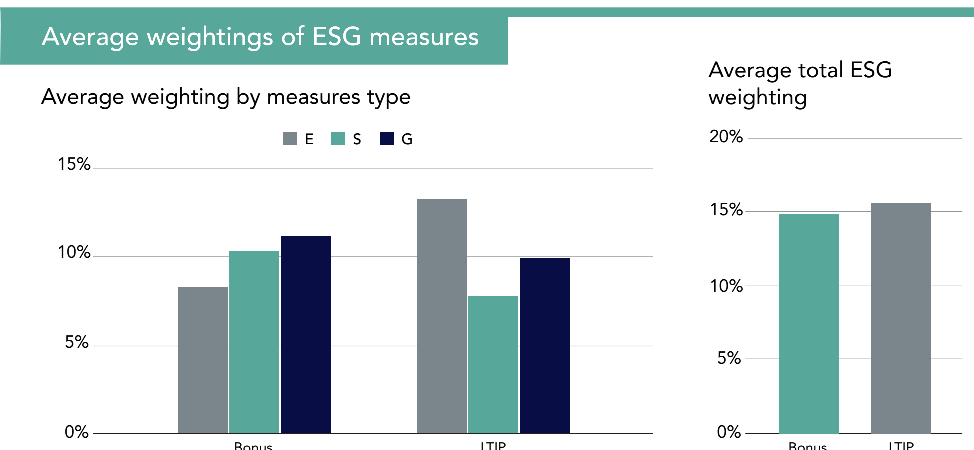

Figure 8: Weighting of ESG metrics in STIs and LTIs (Source: PwC and London Business School)

It should be noted that the same weighting for STIs and LTIs does not mean the same economic significance. If LTIs constitute a large part of the total incentives for an executive for instance, the same weighting would have a larger impact.

Academic insights

In a recent working paper, Professor David Walker, a law professor at Boston University, argued that if LTIs make up most of the pay-at-risk, as is generally the case for large US companies, including ESG metrics only in STIs, even with a relatively heavy weighting, may have little economic significance and therefore little incentive effect. Professor Walker only considered explicit, non-discretionary ESG incentives, whilst the surveys covered in this section included companies that use less explicit and more discretionary ESG incentives.

Overall, for both STIs and LTIs, weightings of 5% to 25% for ESG metrics are relatively common around the world for companies that incorporate such metrics in their plans, but these metrics may not necessarily be explicit, non-discretionary in nature.

SHORT-TERM VERSUS LONG-TERM INCENTIVES

IN A NUTSHELL

Should ESG metrics be incorporated into short-term incentives (STIs), long-term incentives (LTIs) or both?

In general, companies should have both STIs and LTIs in place. LTIs are necessary to motivate executives to take a long-term view, while STIs are necessary to recognise executives for progress in meeting annual goals that are aligned to long-term value creation and success. However, the balance between STIs and LTIs depends on factors such as the business and the ownership of the company.

Some key considerations for companies in deciding whether to incorporate ESG factors into STIs or LTIs are:

- If a company decides that linking ESG to remuneration is important, then the incentives related to the achievement of ESG goals should be economically meaningful. If most of the incentives for executives are through LTIs, then it is important to ensure that ESG metrics are not just linked to STIs.
- Whether to link ESG metrics to STIs or LTIs may depend on the kind of ESG metrics. For instance, certain environmental metrics may be better suited for LTIs.

A 2020 report covering the largest companies in several markets generally show that ESG measures are much more widely used in STIs than LTIs across all the markets (Figure 9).[49]

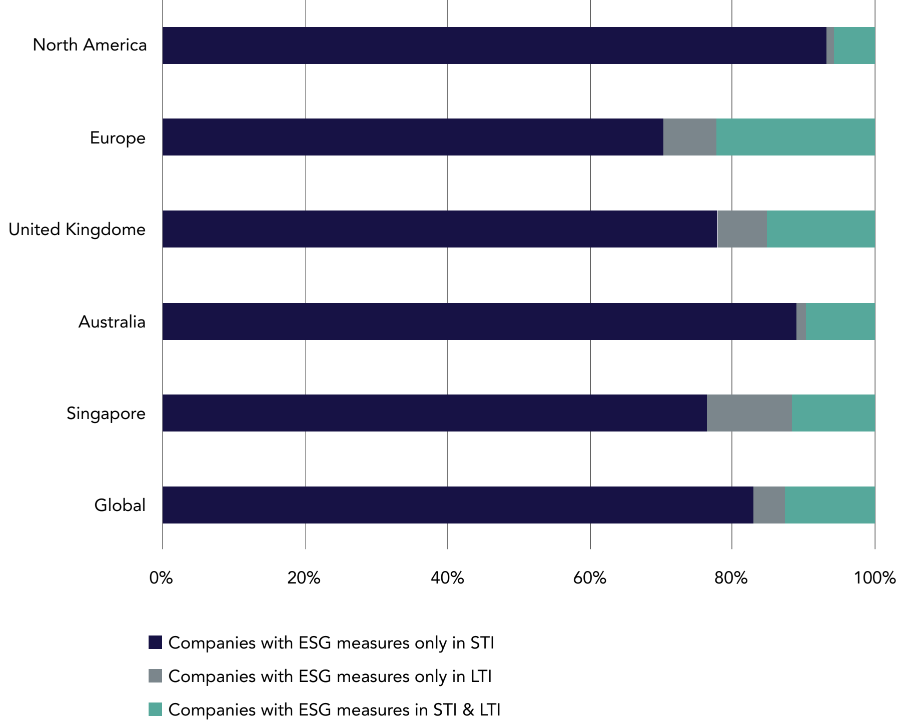

Figure 9: Adoption of ESG factors in STIs and LTIs Across Different Markets (Source: Guerdon Associates and GGECG)

Other surveys confirm this. A report by ISS Corporate Solutions in February 2022 found that adoption of ESG factors in STIs is significantly higher than in LTIs across companies in UK, Ireland, Europe and US, and for both large and smaller companies in the US (Figure 10).[50] However, the use of ESG factors in LTIs is growing rapidly for companies in UK, Ireland and Europe.

Expanding adoption of ESG factors in executive compensation percentage of companies with disclosured ESG metric

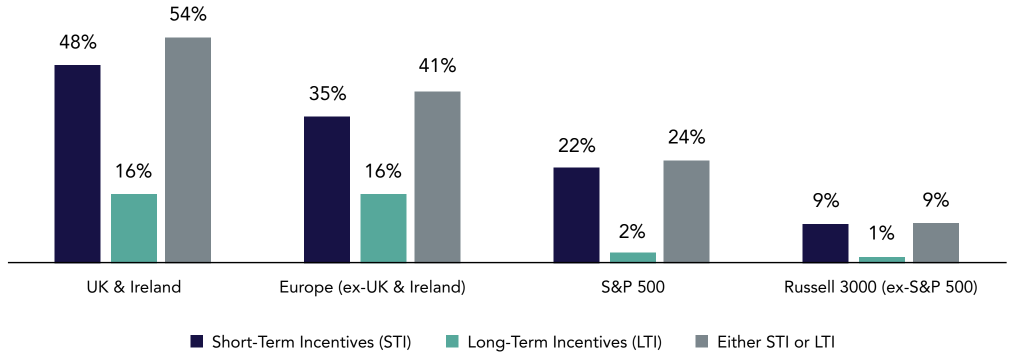

Figure 10: Adoption of ESG factors in STIs and LTIs (Source: ISS Corporate Solutions)

Similarly, a report published in November 2021 shows that while 68% of companies across US, Canada and Europe incorporate ESG metrics in their incentive plans, only 13% do so for their LTIs compared to 66% for STIs (Figure 11).[51] The use of ESG metrics in LTIs is increasing at a faster rate compared than STIs in Europe, but this is not the case in US and Canada.

Prevalence of ESG metrics in executive incentive plans

Overall prevalence of ESG metrics on the US, Canada and Europe - a regional comparison

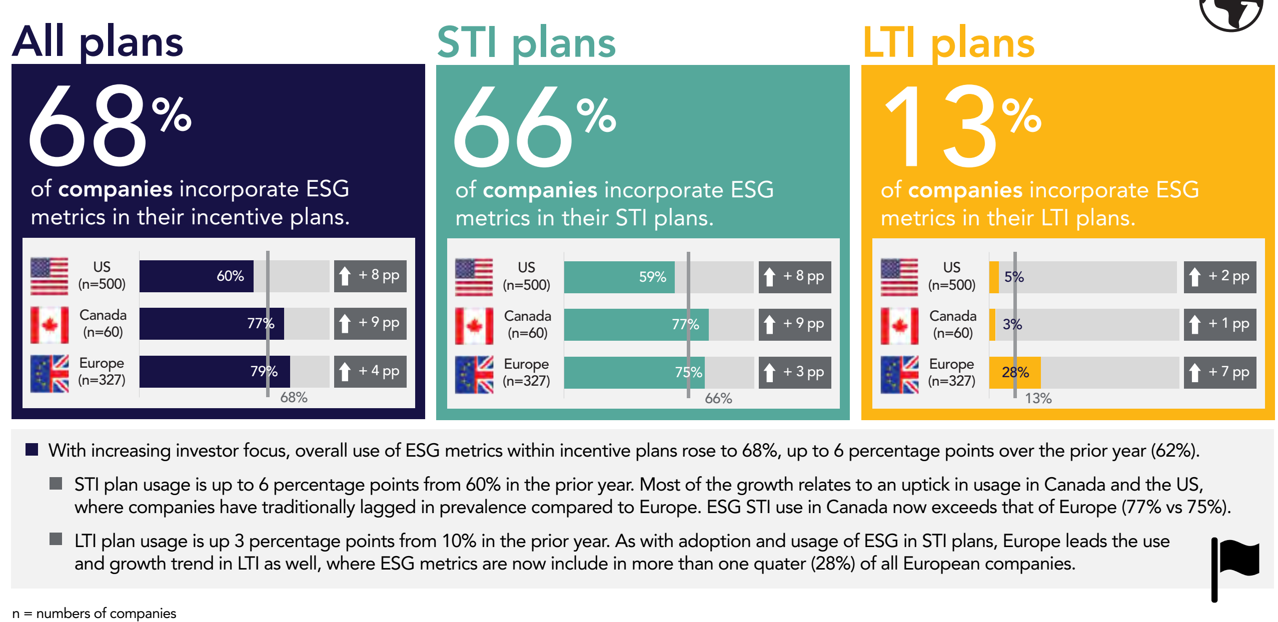

Figure 11: Growth in Use of ESG metrics in STIs and LTIs (Source: WillisTowersWatson)

Academic insights

Professor David Walker from Boston University examined ESG-based CEO pay arrangements at a subset of companies with leadership positions on the Business Roundtable, an industry trade group that embraced ESG in a 2019 statement of corporate purpose.[52] He found that in almost all cases, explicit, non-discretionary ESG incentives are economically insignificant relative to executives' incentives from their share ownership and equity-based compensation. All but one of these companies incorporated explicit, non-discretionary ESG incentives only in annual bonus plans, even though long-term incentives account for about two-thirds of the present value of executive pay at large US companies.

The sole Business Roundtable company studied which tied CEO (long-term) equity pay to ESG performance was Duke Energy, and in so doing created a meaningful link between pay and ESG performance. However, while investors reportedly applauded the company's expanded net-zero emissions commitment,[53] a second party opinion of its Sustainability Financing Framework only assessed it as "satisfactory".[54]

Professor Walker remained unconvinced about this approach, and said: "If directors, executives, and the market all agreed that sustainability efforts, for example, were the most efficient way to boost share price, share-based pay would be sufficient and target incentives unnecessary."[55]

INTERNAL TARGETS VERSUS EXTERNAL BENCHMARKS

IN A NUTSHELL

Should ESG performance be measured against pre-set internal targets or external benchmarks?

Most international companies that are relatively advanced in their journey of incorporating ESG factors into executive remuneration appear to use mostly internal targets.

Some key considerations for companies are:

- If realistic internal targets can be set through a robust goal-setting process, they can better reflect the company's context and may be more suitable.
- While external comparisons against peers and ESG ratings can increase objectivity and provide a more comprehensive basis for assessing performance, there may be challenges in choosing appropriate peers and obtaining comparable information
- The lack of consistency among external ESG ratings limits their usefulness as a major basis for assessing ESG performance.

If ESG metrics are used, there is the question of how performance should be evaluated. A recent article provides a useful framework for considering evaluating ESG performance against internal targets set as part of goal-setting, relative to peers, or based on external ESG ratings, and their pros and cons (Figure 12).[56]

Methods	Pros	Cons
ESG Targets (Internal) (Objectives for activities, projects and ESG results set by the company as a goal)	+ Target setting already needed in management process + Tangible (line of sight) + *Internally controlled*	– Political and costly (internal negotiations) – Realistic (instead of challenging) – Inflexible (priorities and technologies change) – Expression of mistrust (why incentivise a supposedly shared goal)
ESG Relative Performance Measurement (External) (Compared to peers on the basis of key figures the company considers relevant)	+ Minimal target negotiation + Challenging (outperformance rewarded) + Flexible (accounts for new technologies, priorities and economic cycles) + Maintains trust and intrinsic motivation; reduces conflict and engenders alignment + *Partially internally controlled*	– Possible discussion on comparability of metrics and peers – Need for data collection and observation of peers – Loss of "Performance Story" authority – *Partially externally controlled*

ESG Ratings Agencies (External) (Refinitiv, S&P Trucost and RobecoSam, Sustainanalytics, ISS ESG, MSCI ESG, Vigeo Eiris, Ecovadis, etc.)	+ Widely accepted expertise + Independent + No internal target negotiations	– Non-transparent process (competitive industrial and trade secrets) – Differences in values and opinion with rating agency cannot be resolved (e.g. weightings) – Static (A,B,C…small incremental changes) – Externally controlled
ESG Performance Evaluations (Internal or independent performance assessments by means of expert opinions, based on internally and externally objective and subjective facts)	+ Highly motivating + Challenging and flexible (like relative performance measurement) + Combined use of other three methods possible + *Internally controlled*	– Requires trust – Requires effort and relevant knowledge – Discretionary evaluations are no longer widely accepted (though widely practised in the past, and still today by privately owned companies)

Figure 12: Methods of ESG Performance Measurement (Source: Hermann J. Stern)

ESG performance can also be evaluated on a discretionary basis by internal or independent parties (such as the remuneration committee). Such an approach can include consideration of internal targets, peers and external ratings. While it is the most comprehensive, it is also the most subjective. Its acceptance will likely be highly dependent on the degree of trust that investors have in the remuneration committee and board.

Internal and external ESG KPIS: The case of Charoen Pokphand Foods public company limited (Thailand)

In its 2020 Annual Report, Charoen Pokphand Foods in Thailand disclosed that the CEO performance is evaluated annually on the basis of two major indicators: (1) financial indicators such as revenue, market capitalisation, and profitability, including EBITDA margin, return on equity and net profit margin; and (2) sustainability performance indicators, "namely sustainability assessment results by external organisations such as Dow Jones Sustainability Indices, FTSE4Good Index, MSCI ESG, CDP Scores (Carbon Disclosure Project) and survey projects on corporate governance of listed companies, etc. as well as the organisation's implementation results on sustainable development goals 2030, which includes employee engagement".

BALANCING OBJECTIVITY AND DISCRETION

IN A NUTSHELL

How can the remuneration committee balance objectivity and judgment when evaluating ESG performance in determining executive remuneration?

Investors increasingly want to see a connection between ESG factors and executive remuneration. However, they generally prefer metrics that are specific and measurable.

In some international companies, such as the oil majors, the incorporation of ESG factors into remuneration has evolved into highly formulaic approaches, with specific and measurable metrics; clear weightings; quantitative targets for different levels of performance; and actual outcomes for each metric. An overall score is then calculated and used for determining annual incentive payouts and/or LTIs.

In many other companies, ESG metrics that are used are less specific and measurable and the remuneration committee/board has much wider discretion.

Some key considerations for companies are:

- Even in cases where highly formulaic approaches are used, the remuneration committee/board should have the discretion to adjust the actual payout. Making downward adjustments are generally non-contentious but this may not be the case for upward adjustments.
- Companies should be transparent if they incorporate ESG factors into executive remuneration. Remuneration committees and boards should able to explain how they assess performance on the ESG factors so that they are not seen as "soft targets" that are used to inflate executive remuneration.

The survey by ISS Governance cited earlier in the report shows that investors and non-investors (including companies) hold different views about the importance of objectivity of ESG metrics in executive remuneration programs.[57] While 52% of investors felt it useful to incorporate ESG metrics only if the metrics are "specific and measurable" and "their associated targets are communicated to the market transparently", only 27% of non-investors believed this to be an important consideration. In contrast, while 46% of non-investors thought that ESG metrics that are not easily measurable can nevertheless be useful if chosen well, only 34% of investors felt that way.

Earlier in the report, we also cited examples such as Starbucks and Danone S.A. where the CEOs have been assessed to have done well on ESG goals set by the company, but nevertheless left their companies, purportedly because of employee or investor discontent. This raises issues as to whether the ESG metrics chosen, which were largely subjective, accurately captured the ESG performance of these companies. In Danone's case, the CEO was assessed to have performance of 100% for the social, societal and environmental component and 100% in the "managerial" category – both of which were measured rather subjectively – but only 16.6% in the "economic" category, which was measured by objective financial metrics.

Investors' preference for objective measures, coupled with regulatory reforms requiring specific ESG metrics to be disclosed, are likely to lead to an increase in use of objective measures.

However, as was pointed out earlier, relying purely on a few measures, even if measured objectively, may result in "hitting the target and missing the point". Even with objective ESG metrics, there is the question of whether targets that are set are easily achievable or provide an appropriate degree of "stretch".

It is unlikely that purely objective measures will adequately capture all the material ESG issues. Therefore, some subjective measures and the exercise of judgement by the remuneration committee and board will likely be necessary. The exercise of judgement should include discretionary adjustments to incentive payouts which are determined through a formulaic approach. Upward adjustments may increase investor skepticism if not well explained.

Whether objective metrics, subjective performance evaluation or a combination of both are used, the key is good remuneration governance, transparency, and engagement with stakeholders.

Not a Shell Game

The 2021 Annual Report and Accounts of Shell plc (formerly Royal Dutch Shell plc) is a good example of a rigorous and transparent approach to linking ESG metrics to the remuneration of executive directors and senior management, which nevertheless involves the exercise of discretion by the Remuneration Committee (REMCO).

In May 2021, it became the first energy company to ask shareholders to cast an advisory vote on its energy transition strategy, and received support of 88.74% of votes cast. In October 2021, it set a new target to halve the absolute emissions from the company's operations and the energy it uses to run them by 2030, compared with 2016 levels, on a net basis.

For its annual bonus, Shell uses the following KPIs and weightings: financial delivery (35%), operational excellence (35%), progress in the energy transition (15%) and safety (15%). Each has clearly spelt out and individually-weighted metrics. Progress in the energy transition is measured by greenhouse gas emissions intensity in tonne CO_2e intensity (10%) and greenhouse gas abatement in thousand tonne CO_2e (5%). Numbers are disclosed for "threshold", "target", "outstanding" performance and actual outcome for each measure. For greenhouse gas emissions intensity, it is further divided into upstream/midstream, refining GHG and chemicals, again with "threshold", "target", "outstanding" and actual outcome for each disclosed, together with their individual weightings of 4%, 4% and 2%.

Safety is measured by personal safety, based on serious injury & fatality frequency cases per 100 million working hours (7.5%) and process safety based on number of events (7.5%).

Based on the formula, the overall mathematical performance outcome for the 2021 annual bonus was 1.32 (target bonus of 100% would be paid with a performance outcome of 1.00).

Shell disclosed that eight employees were killed in 2021, six in an attack by gunmen in Nigeria, one in a refuelling accident in Pakistan, and another in a construction accident in Indonesia. The company said it took into account the impact of the fatalities on the formulaic outcome and made a **discretionary adjustment**. It explained: "The REMCO carefully considered the fatalities in the context of Shell's overall safety performance in 2021. It took account of the impact the fatalities had on the formulaic outcome. Without the fatalities, the overall scorecard outcome would have been 1.37, not 1.32, reflecting the heavy emphasis that SIF-F [serious injury & fatality frequency] rightly gives to serious incidents. The REMCO determined that the overall scorecard outcome should be further adjusted downwards to 1.29. The overall reduction in the bonus outcome for the CEO and CFO as a result of the fatalities is equal to 10% of their base salary."

Shell also disclosed that its 10-year average scorecard outcome for the annual bonus was 1.03.

In 2021, Shell also included for the first time "energy transition" as one of the KPIs for the vesting of its 2019 LTI plan. This is weighted 10%, with weightings of the other four financial measures adjusted downwards to 22.5% each.

"Energy transition" is to measure progress in transforming Shell's businesses for a low-carbon future and the company explained that it "is a broad metric that assesses performance against a range of strategic business developments, as well as measuring our ultimate success in reducing the net carbon intensity of all energy products sold". It further explained the specific metrics that were considered. For 2021, "the REMCO determined that the final vesting outcome of the element of the 2019 LIPT weighted to the energy transition should vest at 180%".

While the "intensity reduction target based on the full Scope 1, 2 and 3 emissions from all energy products sold" is objective, with the company disclosing a reduction of 2.5% against a target range of 2-3%, some of the metrics considered for "energy transition" are qualitative in nature.

At Shell's AGM held on 18 May 2021, 95.86% of the total shares voted supported the advisory resolution on the directors' remuneration report for 2020.

ESG-LINKED REMUNERATION PRACTICES IN ASEAN

IN A NUTSHELL

ASEAN companies are only starting the journey in incorporating ESG factors into executive remuneration, with this practice most common among companies in Singapore. As this report indicates, there are many issues that companies need to consider as they embark on this journey.

Some key considerations for ASEAN companies as they embark on the journey to incorporate ESG factors into executive remuneration are:

- Remuneration committees and boards should assess whether there are specific material ESG factors that are relevant to the company and business
- If a decision is made to link ESG factors to executive remuneration, they should start the process with a materiality assessment of ESG factors
- There should be robust discussions relating to issues raised in this report, such as choice of metrics, setting of targets, and whether to use stand-alone ESG metrics or a scorecard, and weighting

This section of the report examines the extent to which large ASEAN listed companies are incorporating ESG factors into executive remuneration. The companies selected are the 135 ASEAN companies which were named as ASEAN Asset Class companies in the 2019 ASEAN Corporate Governance Scorecard Awards.[58] The companies come from six ASEAN markets – Indonesia (10 companies), Malaysia (37), Philippines (19), Singapore (26), Thailand (42) and Vietnam (1).

Only 21, or 16%, of companies across four ASEAN countries – Malaysia, Philippines, Singapore and Thailand – explicitly disclosed that ESG factors are incorporated into executive remuneration. The highest percentage of companies doing so is in Singapore, with 38.5% of the 26 Singapore companies disclosing that they do so (Figure 14). We excluded companies that merely disclosed the use of traditional non-financial KPIs, such as those related to people development, and only included companies that clearly disclosed they were incorporating ESG- or sustainability-related KPIs.

Companies Incorporating ESG Factors Into Remuneration

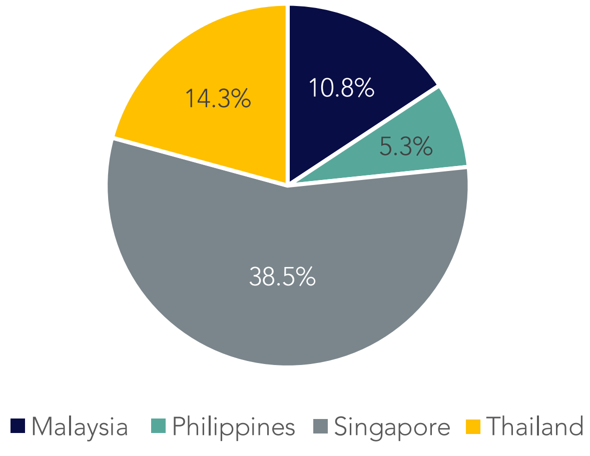

Figure 14: Percentage of ASEAN Asset Class Companies Incorporating ESG Factors Into Executive Remuneration

Of the 20 companies that disclosed what ESG factors they linked to remuneration, all stated that they incorporated environmental factors, 18 said they included social factors, and seven disclosed certain governance factors (Figure 15).

ESG Factors Linked To Remuneration

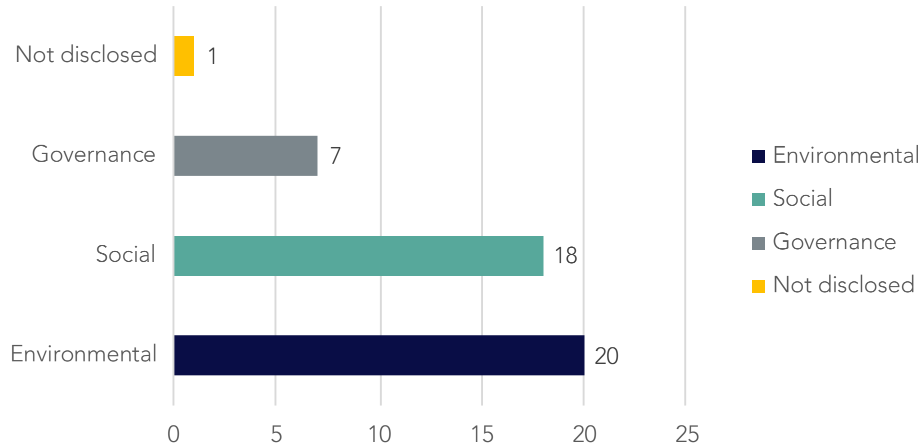

Figure 15: Type of ESG Factors Into Executive Remuneration

For companies that disclosed that they incorporated ESG factors in executive remuneration, specific details are often lacking.

Of the 11 companies that disclosed information on what ESG metrics are used, four disclosed quantitative metrics, three disclosed qualitative metrics and another four disclosed both quantitative and qualitative metrics. These metrics may be just a selection of the metrics used by these companies (Figure 16).

Quantitative or Qualitative Metrics

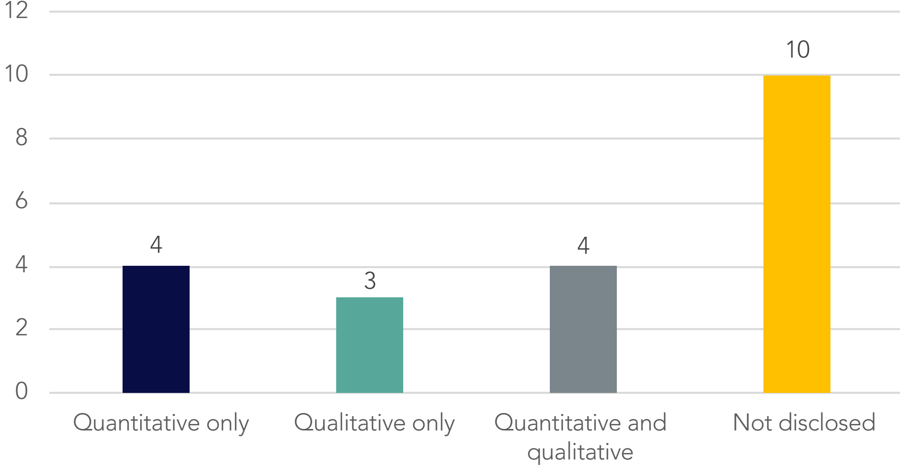

Figure 16: Quantitative Versus Qualitative Metrics

Only six companies disclosed how the metrics are linked to executive remuneration, with four disclosing having a separate ESG scorecard and another three which included ESG metrics as part of an overall balanced scorecard that also included non-ESG factors (Figure 17). No company disclosed having individual metrics with their own weightings.

Individual Metrics Versus Scorecard

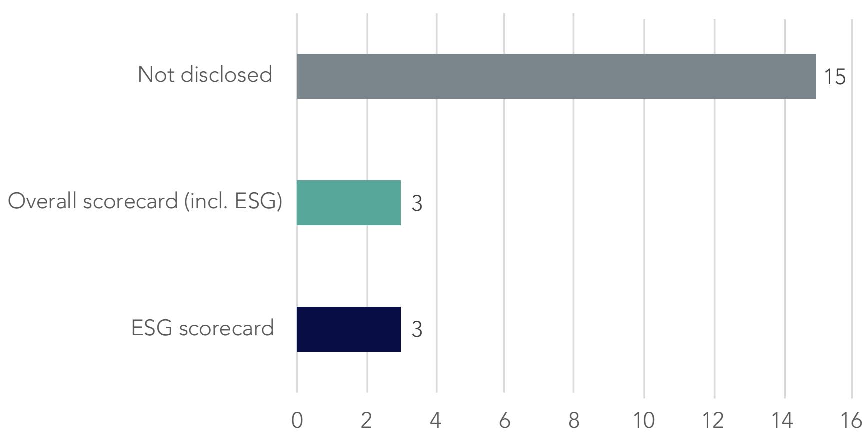

Figure 17: Methods of Incorporating ESG Metric into Executive Remuneration

Ten companies disclosed the types of targets or benchmarks used for assessing ESG performance. Seven disclosed the use of internal targets and three disclosed a combination of internal and external targets (Figure 18).

Internal Versus External Targets

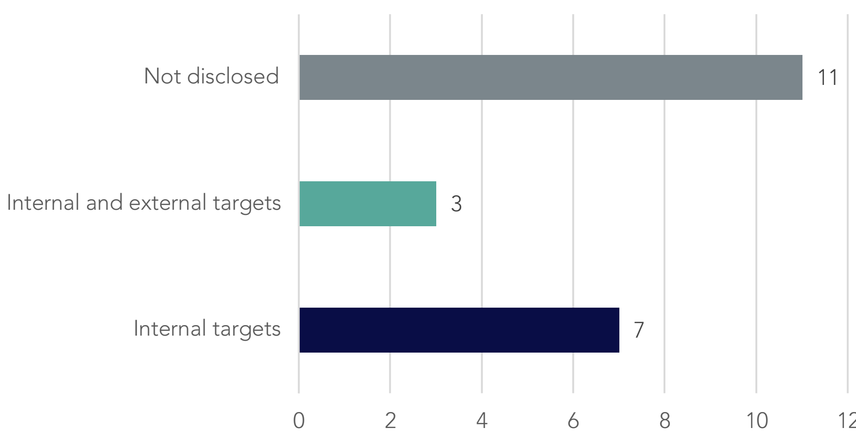

Figure 18: Internal Versus External Targets

Companies generally linked ESG metrics to STIs. Where there are LTIs, only three companies clearly disclosed that they are linked to LTIs, with two linking to both STIs and LTIs and the other only to LTIs.

Clearly, ASEAN companies are only starting the journey to considering integrating ESG factors into executive remuneration, and those that do so do not disclose much information on how it is implemented.

Top Glove's Journey

Top Glove, the largest glove manufacturer in the world with a primary listing on Bursa Malaysia and a secondary listing on the Singapore Exchange, had stellar financial performance when the COVID-19 pandemic hit, as it benefited from the huge surge in global demand for gloves. Its net profit attributable to shareholders grew by 381% from FY2019 to FY2020, and another 340% from FY2020 to FY2021, while its return on equity over the same period increased from 14.4% to 26.0% and then to 131.3%. Share price surged by 454% between the end of FY2019 and FY2020, before falling back 54% between the end of FY2020 and the end of FY2021.

While Top Glove's business was thriving, it came under considerable public scrutiny for its labour practices, such as poor living and working conditions of its migrant workers, forced labour practices which led to import bans of its products by the US, and questionable handling of a whistleblower complaint. The board was criticised by some influential institutional investors, who voted against the re-election of six independent non-executive directors (INEDs) – although they were nevertheless re-elected.

In response, the company revamped its remuneration policies for management in FY2021, seeking to ESG factors to executive remuneration.

Changes in remuneration policy

In its Integrated Annual Report for the financial year ended 31 August 2021, Top Glove disclosed the following:

"Our management incentives or remuneration pay are linked to ESG metrics, ensuring management accountability for the achievement of the Company's goals. In FY2021, the Group has set 40% of the FY2022 Key Performance Indicators (KPIs) tied to social and environmental pillars, which are aligned with the Company's material ESG matters. To reflect the Company's commitment in transitioning into a net zero carbon business, the Group introduced carbon emission reduction as new KPI for FY2022."

In various parts of its Integrated Report, it mentioned this 40% linkage of ESG metrics to management pay for FY2021, and as one of the key achievements and highlights for the year.

ESG KPIs and metrics

The following ESG KPIs and metrics, are used:

1. Product Quality and Safety Customer complaint rate	**3. Human Rights & Labour Practices** Social ethical audit scoring	**5. Talent Retention** Employee turnover rate
2. Occupational Health & Safety Occupancy accident rate	**4. Reduce Carbon Emission** Scope 1 & 2 emissions intensity reduction	

In the company's 2021 Integrated Report, the company disclosed its assessment of the materiality of ESG issues. The six ESG issues assessed to have the highest impact on stakeholders and greatest significance to the company's business were: (a) product quality & safety; (b) occupancy health & safety; (c) labour management relations; (d) human rights; (e) customer experience; and (f) environmental compliance.

There is a strong alignment between the company's materiality assessment and the ESG KPIs linked to management pay. While a company's materiality assessment may not necessarily reflect the ESG factors that stakeholders consider to be most important, the ESG issues identified by Top Glove through its materiality assessment appear to be factors that would be important for the company.

For each KPI, the company has also identified a metric which is measurable. This would address common concerns among investors about subjectivity of ESG KPIs.

Further, it disclosed short-term and mid-term targets for the various ESG metrics.

However, while the company disclosed an overall 40% weighting for the ESG KPIs, it did not disclose the individual weighting for the KPIs.

The company also did not clearly disclose whether it linked the ESG metrics to annual incentive pay or long-term incentives, which in its case comprise employee share grants and employee share options – or to both.

Impact on remuneration

Based on a review of the actual remuneration of its executive directors (EDs) and key management personnel (KMP) for FY2021, it is unclear how the ESG metrics actually impacted their remuneration.

Only two of the top 10 executives received a bonus in FY2021 – one of the EDs and another KMP who received a negligible bonus. It is unclear if most of the executives did not achieve their ESG goals and other KPIs.

In the previous FY2020, three of the four EDs received bonuses. That year, it disclosed the exact remuneration of three other KMP, with two receiving bonuses. In FY2019, only one of the four EDs – the EC – received a bonus. The three KMP who are not EDs did not receive bonuses.

Overall, there appears to be little short-term incentive pay for the KMP, particularly those who are not EDs. For the EDs and other KMP, it is currently unclear how ESG (and other) goals affected their bonuses. It is also unclear whether ESG metrics are linked to long-term incentives, that is, to the award or vesting of shares and share options.

While Top Glove has started the journey, there is still a missing link between ESG and executive remuneration.

What's Next for ASEAN?

The ASEAN companies which currently disclose that they are incorporating ESG factors into executive remuneration generally disclose little information about how it is implemented. For example, disclosures of what specific ESG factors are considered, how they are selected, metrics that are used, targets that are set, and how they are linked to remuneration, are often lacking.

Similar to the trend seen in other international markets, where institutional investors are increasingly expecting companies to incorporate ESG factors into executive remuneration, institutional investors are likely to raise this important issue with ASEAN companies. At the same time, they are likely to demand more transparency on how this is done.

The recent exposure draft issued by the International Sustainability Standards Board on general requirements for disclosure of sustainability-related financial information, para 13(f), states that entities should disclosure how the governing body and its committees "oversee the setting of targets related to significant sustainability-related risks and opportunities…including whether and how related performance metrics are included in remuneration policies".[59] The adoption of this standard will require ASEAN companies to ensure that their disclosures are sufficiently clear to allow investors to understand the linkage between ESG factors and executive remuneration.

This report discusses the key issues that boards and remuneration committees should consider when integrating ESG factors into executive remuneration and provides guidance on information that companies should consider disclosing.

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ABOUT THE AUTHOR

Mak Yuen Teen is Professor (Practice) of Accounting at the NUS Business School, National University of Singapore (NUS). He was a former Vice Dean of the School and the founder of the first corporate governance centre in Singapore at NUS. He holds first class honours, master and PhD degrees in accounting and finance, and is a fellow of CPA Australia.

Prof Mak has served on three of the four corporate governance committees set up by the Singapore authorities to develop and revise the code of corporate governance for listed companies, including the first committee in 2000 and the most recent committee under the Monetary Authority of Singapore (MAS) which released the 2018 Singapore Code. He currently serves on the Corporate Governance Advisory Committee under MAS aimed at continually raising corporate governance standards for listed companies in Singapore.

Each year, he edits a collection of Asia-Pacific and global case studies which are published by CPA Australia and so far, ten volumes, a special financial services edition, and several volumes translated into Chinese and Vietnamese have been produced. In all, he has written or edited over 220 case studies related to corporate governance. Many of the recent case studies deal with ESG issues.

He developed the first corporate governance rating for Singapore companies called the Governance and Transparency Index and the first Singapore governance rating for REITs and business trusts. He was nominated by MAS as the Singapore expert in the development of the ASEAN CG Scorecard.

Prof Mak has extensive experience conducting training for directors, regulators and other professionals in Singapore and Malaysia, including the mandatory accreditation programme for Malaysian directors, the FIDE program for directors of Malaysian financial institutions, and programs relating to nomination and remuneration matters.

Prof Mak is also a regular commentator on corporate governance issues in the Singapore and international media, and regularly posts articles and commentaries on his website Governance for Stakeholders.

He is only one of two individuals in Singapore to have been given the Corporate Governance Excellence Award by the Securities Investors Association (Singapore) for his contributions to improving corporate governance in Singapore. The Singapore Institute of Directors has also recognised him as a CG Pioneer. He also received the corporate governance excellence award from the Minority Shareholders Watchdog Group in Malaysia for his contributions to corporate governance in the region.

CPA Australia (Singapore office)

1 Raffles Place
#31-01 One Raffles Place
Singapore 048616

P : +65 6671 6500
E : sg@cpaaustralia.com.au
W : cpaaustralia.com.au

Sustainable Finance Institute Asia

140 Paya Lebar Road
#09-24 AZ @ Payar Lebar
Singapore 409015

E : contact@sfinstitute.asia
W : www.sfinstitute.asia

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