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The growing importance of ESG-linked compensation systems

More than just a buzzword

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The concept of sustainability has grown in importance across a range of industries. Companies are increasingly recognizing their responsibility to address environmental, social and governance (ESG) issues. Sustainability is gaining public attention and, as a result, economic value. One critical area where ESG principles can be effectively integrated is in compensation systems. In this article, we explore the importance of sustainable compensation, the relevant regulatory frameworks, and practical steps for implementation.

Regulatory pressure is increasing

Both national and international regulations now emphasize ESG considerations in remuneration systems. In particular, reporting and transparency requirements have been introduced for larger companies and certain industries:

- In Germany, the Act on the Appropriateness of Management Board Remuneration (Gesetz zur Angemessenheit der Vorstandsvergütung – VorstAG) has already led to the inclusion of sustainability in the remuneration structure of listed companies since 2009.
- According to the Second Shareholder Rights Directive (SRD II), which was introduced in 2017 and aims to strengthen shareholder engagement and increase transparency, shareholders not only have a general "Say on Pay", it also stipulates that the remuneration structures of the management boards of listed companies must be aligned with the "sustainable" and "long-term development" of the company. Germany has implemented this directive with the ARUG II (Gesetz zur Umsetzung der zweiten Aktionärsrechterichtlinie – ARUG II).
- Financial market participants and financial advisors must include in their compensation policies information on how these policies are consistent with the integration of sustainability risks, and publish this information on their websites in accordance with the EU Regulation on sustainability disclosures in the financial services sector (2019/2088).
- In Germany, the German Corporate Governance Code (Deutscher Corporate Governance Kodex – DCGK) defines a long-term and sustainable approach to executive remuneration, which is recognized by practitioners as a valuable guideline for management and supervisory boards.
- Most recently, in April 2024, the European Parliament formally adopted the Corporate Sustainability Due Diligence Directive (CSDDD), which legally requires large companies with significant operations in the EU to conduct human rights and environmental due diligence in their own operations and throughout their supply chains. In Germany, this has already been regulated at national level by the Supply Chain Responsibility Act (Lieferkettensorgfaltspflichtengesetz – LkSG). Even companies that are not strictly legally subject to the aforementioned laws have often already defined sustainability targets as a voluntary commitment.

First steps toward an ESG-linked compensation system

Companies have a lot of room for maneuver when it comes to implementing sustainable remuneration systems. The first step is to make management aware of what ESG compliance means for the company in concrete terms, and of the attitudes of customers, shareholders, investors and employees. This is often achieved by emphasizing the increasing business value of ESG compliance: It is more than just a buzzword when it makes money.

The selection of sustainability criteria and targets is as individual as the industry and the company itself. Each company is entitled to exercise its own judgment in the selection of sustainability targets. The combination and weighting of the individual sustainability targets must be selected on a company-specific basis, depending on the company's particular industry. For an industrial company, such targets may be very different from those chosen by a service company.

The following ESG targets are regularly used to take sustainability aspects into account when determining remuneration:

- **Environment**: e.g., measures to improve energy efficiency, reduce greenhouse gas emissions or use electricity from renewable energy sources

- **Social**: e.g., measures in the areas of diversity, occupational health and safety, training and development opportunities, and customer or employee satisfaction

- **Governance**: e.g., measures in the area of compliance, the introduction of whistleblower systems, the prevention of corruption and bribery, risk management systems or the area of sustainable supply chains, but also in the area of communication within the company itself

Linking targets to compensation

The first obvious way to link ESG performance to remuneration is through variable compensation, either in a Short-Term Incentive Plan (STIP) or in a Long-Term Incentive Plan (LTIP). Targets with a more short-term horizon (e.g., the implementation of governance policies) are better suited to an STIP, while targets based on a long-term planning horizon (e.g., the reduction of CO_2 emissions) are better suited to an LTIP. In both the STIP and the LTIP, ESG objectives can be combined with financial and operational objectives in an additive or multiplicative manner.

Even fixed compensation can reflect social responsibility to the extent permitted by applicable labor laws. Typically, companies can structure fixed compensation to be consistent with ESG principles, emphasizing fairness and equality in pay. Salary increases can also be linked to the achievement of ESG targets.

Finally, sustainability can also be promoted beyond a purely financial payout (e.g., through other benefits, such as extra leave, company cars and incentive events) or by making the achievement of sustainability targets a criterion (e.g., for promotions).

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At the same time, ESG targets should be translated into action through the application of these remuneration systems, not only to senior executives, but perhaps also to the broader workforce, so that each employee is motivated and financially rewarded for contributing to the selected ESG targets within their sphere of influence and operations.

In order to create a clear incentive to pursue an overall sustainability strategy, it is generally recommended that ESG targets should account for at least 10-30% of total (variable) compensation. For example, Adidas (adidas AG) recently published its 2024 compensation system for Executive Board members. Twenty percent of each Executive Board member's LTIP bonus is linked solely to individually agreed and measurable ESG targets.

Finally, ESG targets should be Specific, Measurable, Achievable, Relevant and Timely (SMART). In particular, the ESG targets selected should be measurable. Of course, "ESG" as a buzzword is not an appropriate target, because it cannot be measured. Creating measurable ESG targets involves defining metrics or Key Performance Indicators (KPIs) against which success can be measured (e.g., "Reduce the company's water consumption by 20% by 2025", "Implement a supplier code of conduct by the end of 2024").

Labor law implications

- Equal pay and anti-discrimination: It goes without saying that the implementation of an ESG-based remuneration system should not violate equality rights or discriminate based on gender, ethnicity or other protected characteristics.

- Collective bargaining agreements: With the exception of senior executive compensation, compensation is often governed by collective bargaining agreements, which may give companies less room to maneuver. However, trade unions tend to be very supportive of ESG compliance, so company-specific pay schemes can be implemented through company agreements where appropriate.

- Works council co-determination rights: In Germany, issues relating to compensation structures are generally subject to the co-determination right of works councils and must not be implemented for the wider workforce without a works council agreement [Section 87 (1) No. 10 BetrVG]. This applies, for example, when considering ESG targets for compensation, but also when introducing job bikes or job tickets to encourage a climate-friendly commute.

Conclusion

Implementing a sustainable compensation system is more than just checking another ESG buzzword box; it reflects a commitment to responsible business practices, as well as a fair, equitable and environmentally-conscious workplace. By integrating ESG principles into compensation, companies can drive positive change while meeting regulatory requirements and stakeholder expectations. ←