The Frontier Line

Thought leadership and insights from Frontier

Issue 183 | **September 2021**

ESG-aligned incentives

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About us

Frontier has been at the forefront of institutional investment advice in Australia for over 25 years and provides advice over more than $490 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Frontier's purpose is to empower our clients to advance prosperity for their beneficiaries through knowledge sharing, customisation, technology solutions and an alignment and focus unconstrained by product or manager conflict.

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Senior Consultant

Sarah Cornelius is a Senior Consultant at Frontier and is a member of Frontier's Investment Governance Team having joined Frontier in May 2010 and the Governance team in January 2015. Sarah has considerable experience providing governance advice to investment committees and boards, reviewing and preparing investment policies, as well as undertaking reviews of investment beliefs and internal investment capabilities across a range of institutional investors. She is also a member of Frontier's Responsible Investment Group and Frontier's investment consulting team, providing consulting support to clients and involvement with investment and manager research. Sarah holds a Bachelor of Commerce (Commercial Law) from Swinburne University and a Masters of Applied Finance from Kaplan Professional.

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Simone Gavin re-joined Frontier in 2020 as a Senior Consultant and is a member of the Equities team. Simone previously worked at Lonsec for seven years where she was responsible for undertaking manager research in global and domestic equities, with lead analyst responsibilities for global equities and emerging market equities. Prior to Lonsec, Simone spent five years at Standard & Poor's where she also undertook manager research in global and domestic equities and had lead analyst responsibilities for listed infrastructure and emerging market equities. Simone previously worked with Frontier as an analyst for two years until November 2007. Simone holds a Bachelor of Chemical Engineering (hons) and Commerce from The University of Melbourne and is RG146 compliant.

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Introduction

In a world where we have a better understanding of the urgency for decarbonisation, the benefits of diversity, and more broadly how stakeholder alignment makes up an increasing proportion of a company's value, financial targets are no longer the only consideration in incentivising executives.

Sole reliance on financial incentives can be detrimental if it discourages executives from focusing on the strategic goals linked to long-term value creation. Over time we expect that environmental, social and governance (ESG) factors will have an increasing impact on financial outcomes and there is a growing recognition that incorporating ESG-aligned incentives into executive remuneration makes good business sense, notwithstanding that effective implementation can be challenging.

ESG-aligned incentives refer to elements of corporate incentive structures that are explicitly linked to achieving specific ESG targets. Examples include targets relating to employee health and safety or carbon reduction. These will differ depending on the company/industry and its strategic objectives. They act in the same way as traditional key performance indicators (KPIs) to measure how effectively an individual or group is meeting defined targets. Like KPIs, ESG-aligned incentives should be specific, measurable, achievable, relevant and time phased.

So what types of issues are we talking about when we break down ESG into environmental, social and governance related issues? Examples of ESG factors are shown in table 1.

Table 1: ESG factors for companies and investors to consider

Environmental	Social	Governance
Scope 1, 2 and 3 emissions	Fatalities	At the Board level
Greenhouse gas (GHG) emissions	Injuries	Risk management
Environmental incidents	Diversity & inclusion	Compliance
Percentage of renewable energy used	Employee engagement	Behaviours
Water efficiency	Training & development	Values
Sustainability		Culture

Source: Frontier

ESG issues have become a higher priority for companies and investors/asset owners, driven by a combination of increasing community (including consumers, investors, investor groups, proxy advisers) and regulatory expectations. While formal guidance or regulation around ESG varies in scale and pace across jurisdictions, community expectations have generally evolved at a much faster pace than formal regulatory and legal standards. In some jurisdictions, new regulation has led and driven changes, while in other jurisdictions corporates are seen as proactively leading where regulation is more nascent, commonly in this latter case it is driven by strong community expectations.

The Principles for Responsible Investment (PRI) has also recently updated its view and put out a statement in June 2021 noting it strongly believes that ESG-linked incentives can be an important tool to drive value and better sustainability performance. The research notes that evidence is improving on the link between ESG-aligned incentives and shareholder value (as earlier research had not concluded a meaningful connection) but that academic research is still preliminary.

In this issue of *The Frontier Line*, we look at alignment of incentives for senior executives to ESG objectives in Australian listed companies and outline some action points for ourselves as well as clients. While we have only limited direct contact with Australian listed companies, we spend a great deal of time talking with fund managers and they are our conduit to what companies are doing and how they are progressing their ESG strategy. We surveyed a number of Australian equities fund managers to see how common ESG objectives were in executive compensation within Australian listed companies; whether senior executives were appropriately aligned to those ESG objectives; whether this was in conflict to the long-term success of the company; and what they believed was driving better practices.

The general view by the manager group surveyed was that companies are now expected to play an active role in addressing challenges with ESG, particularly with climate change, and therefore incentive structures should support both the role of the company in addressing these challenges, as well as improving business sustainability. Hence, it makes conceptual sense there is some alignment through incentive structures. But, in reality, it is not always simple to identify and appropriately align ESG metrics with incentives.

While it might sound like a logical next step to introduce ESG-aligned incentives, it is important to understand its efficacy, implementation, and any potential unintended consequences.

"Further examination and guidance on ESG-linked pay is necessary to ensure that it is fit for purpose and does not lead to unintended consequences or pay padding"

Principles for Responsible Investment (PRI)
June 2021.

What is #trending?

In Australia, 'social' metrics like health and safety have been included in executive incentive structures for some time. More recent metrics include those specifically linked to 'environmental' objectives, including lower emissions or green energy scores. A key component for structuring meaningful and effective ESG-aligned incentives are the ESG metrics used and the structure of the ESG-aligned incentives; transparency and alignment to the business strategy are critical.

Policy and regulation

Government policy is a key consideration for any given investment as it defines what the government is going to do (or not going to do), while regulation is effectively the implementation of these policies (the standards, principles and procedures). Much of the current ESG-related regulation for corporations focuses on ESG practices, with a more recent focus on managing and monitoring climate change related risks, specifically about investment practices and disclosure. At a federal level, Australia is considered to be lagging global peers on climate policy. Unlike many of its global peers, Australia has not yet committed to reaching net zero emissions by 2050 (although some states have made decarbonisation pledges, which potentially creates some confusion). This has investment implications both in terms of future development and technology at the company level and capital flows at the investor level.

In the absence of formal guidance, an investor-led approach may include the adoption of voluntary frameworks. The key challenge when it comes to ESG-aligned incentives is that there is currently no universally accepted framework, and while it generally seems to be moving in the right direction, there is still some way to go before we expect to see meaningful consistency on this within sectors across Australian public companies.

The regulatory landscape in the home country of a company will impact its overall approach to managing ESG factors. Depending on the jurisdiction, companies may either be reactive (i.e. where regulation more commonly drives change) or proactive (i.e. where companies/community expectations more commonly drive change).

Australia's approach to ESG-related regulation is relatively nascent, however recent initiatives have started to evolve. Whereas in Europe for example, its introduction of the sustainable finance disclosure regulation (SFDR) in the investment industry is considered leading. The SFDR is part of a broad package of legislative tools designed to direct private capital towards sustainable investing, combat 'greenwashing' and improve disclosure and transparency. (Greenwashing is essentially making a company look like it is tangibly integrating ESG into its processes and products while in reality, it is not). Combatting greenwashing is also a sharp focus of the Australian Securities Investment Commission (ASIC) and The US Securities and Exchange Commission (SEC).

"Some climate risks are distinctly "financial" in nature. Many of these risks are foreseeable, material and actionable now. Climate risks also have potential system-wide implications that APRA and other regulators here and abroad are paying much closer attention to."

Geoff Summerhayes, Executive Board Member APRA, Speech to the Insurance Council of Australia Annual Forum, February 2017.

There is "an inherent harmony between the financial effect associated with climate change risk and the cardinal requirement of a trustee to act in the best interests of (a) beneficiary".

Noel Hutley, QC and James Mack, Memorandum of Opinion entitled "Superannuation Fund Trustee Duties and Climate Change Risk" Published June 2017.

In Australia, regulation naturally plays a role, particularly with regard to governance, workplace health safety and anti-discrimination, but the push for broad ESG-aligned incentives to date has been largely driven by stakeholders, including proxy voting advisors and investor groups. Groups like the Climate Action 100+, a global investor-led initiative, has helped push the world's largest corporate greenhouse gas emitters to take necessary action on climate change. The increased focus on climate change governance and accountability in Australia was also strongly influenced by SC Noel Hutley's legal opinion tying climate change to directors' duties. In addition, the Australian Prudential Regulation Authority (APRA) recently released a new draft prudential practice guide CPG 229 – Climate Change Financial Risks . This guidance will apply to all APRA-regulated institutions including superannuation funds, insurers and banks. CPG 229 provides APRA's view of better practice in the management of climate change financial risks, encouraging a fit for purpose approach that aligns with the achievement of the organisation's business objectives.

Net zero targets are an example of a proactive approach (i.e. company/community driven as opposed to regulatory driven) to managing ESG risks, specifically climate change risk. As more companies (and asset owners) embark on these ambitions, aligning incentives to achieving these goals could create the required motivation and help promote the desired culture to achieve these targets. While the devil is in the detail for how companies that commit to net zero will actually achieve this, it could mean we start to see more companies, for example, explicitly linking greenhouse gas emissions targets under their net zero commitments within incentive structures.

Frameworks

There are a number of voluntary frameworks and emerging practices but so far there is not one that is universally accepted. Adding to the challenge is the different impacts various ESG factors have on companies across various sectors and industries, for example carbon intensity is likely to have greater influence on the financial performance of a high-emitting company than a low-emitting one. It is also worth noting that a specialist industry has developed around ESG (listed company) data but several fund managers noted their frustrations such data is often dated and there is a lack of consistency across the vendors (who are ultimately competing with each other). As disclosure at the company level improves, the consistency and accuracy of this data is expected to improve.

Voluntary reporting frameworks often provide a good structure for ESG-aligned incentives but the challenge is there is no one size fits all approach, it can be very company and/or industry specific.

What does the data say?

In Australia, 'social' ESG metrics like workplace health and safety and employee relations have been incorporated in incentive structures for a number of years, but Australian companies would be considered, broadly speaking, behind corporates in other countries based on 'environmental' ESG metrics like climate change. This is likely driven, at least in part, by Australia lacking firmer policy commitment relative to global peers, as noted previously.

Research by Guerdon Associates reinforced the relevant dominance of 'social' metrics in ESG-aligned incentive structures. Guerdon Associates found the use of ESG-aligned incentives varied by geography and industry, in part driven by the composition of industries within each region. For example, Australia has a high proportion of materials and financial services companies, whereas the US is more diversified and has a high proportion of technology companies. As highlighted in figure 1, based on this research, Australia is a leader in ESG-aligned incentives when measured using Guerdon Associates ESG PlusTM measurement (which also includes other non-ESG related non-financial metrics) with 81 per cent of ASX 100 companies incorporating ESG-aligned incentives. The high percentage reflects the uptake of health & safety measures rather than climate-aligned or environmental factors.

Figure 1: Corporate adoption of ESG-aligned incentives

	Australia	United Kingdom	Europe	Canada	Singapore	United States	**Global
Utilities	100%	100%	100%	50%		100%	91%
Financials	94%	89%	69%	80%	100%	87%	86%
Energy	80%	100%	100%	89%		83%	86%
Materials	88%	79%	67%	90%		50%	81%
Industrials	92%	81%	80%	60%	33%	33%	67%
Health Care	50%	75%	67%	50%		67%	64%
Consumer Staples	80%	60%	71%	80%	33%	55%	63%
Real Estate	90%	67%	33%	0%	70%	0%	63%
Communication Services	50%	75%	60%	50%	100%	33%	55%
Information Technology	50%	67%	50%	0%	100%	60%	51%
Consumer Discretionary	75%	20%	50%	20%	0%	20%	40%
*Total	81%	72%	66%	63%	57%	56%	67%

* Total industry average by region
** Global industry average

MIN — MAX

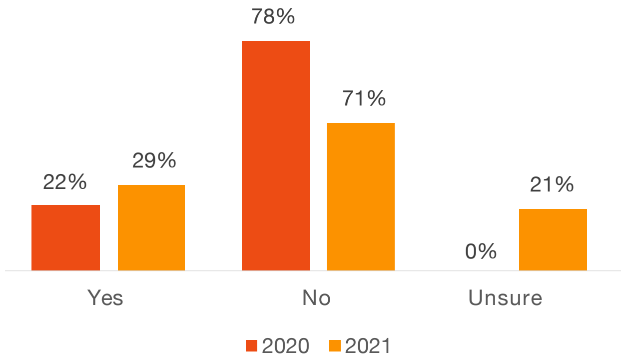
Source: Guerdon Associates. The ESG PlusTM framework for incentive measures includes five categories: social, environmental, customer, community and governance.

Pay Governance has conducted different studies on this topic, one looking at the progress of US companies at incorporating ESG metrics into incentive plans and the second comparing a select sample of US companies to a select sample of companies in Europe and the UK. The former survey conducted by Pay Governance shows while there are a number of US companies that incorporate ESG metrics into incentive plans, there is still a high percentage that either do not or are unsure if they will, indicating a degree of hesitancy amongst companies despite rising community expectations. This may change under the Biden administration as the US SEC is planning to propose new rules by the end of this year, including a push for mandatory public climate disclosures from corporates, as well as heightened scrutiny on the authenticity of investment managers selling sustainable products.

"We've seen a growing number of funds market themselves as green, sustainable, low-carbon and so on…. What information stands behind these claims?"

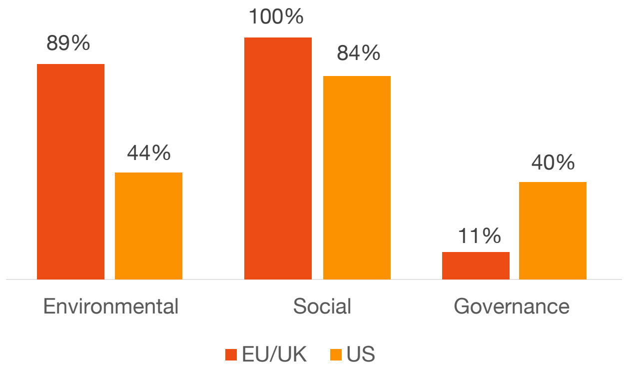
Gary Gensler, Chairman of the US SEC.

Chart 1: US companies incorporating ESG metrics into incentive plans in 2020 versus 2021



Source: Pay Governance.

Chart 2: Type of metrics used in incentive plans



Source: Pay Governance. Based on a survey of 95 US companies, 30 companies from the UK's FTSE 100 and EU's STOXX 50 indices.

The latter study conducted by Pay Governance, comparing Europe and the UK to US companies , also highlighted the dominance of 'social' metrics in ESG-aligned incentive structures. While 'social' metrics were most common, the prevalence of 'environmental' metrics were not far behind, particularly in Europe and the UK.

The use of environmental metrics has been restricted to some extent by historically unreliable or inconsistent disclosures of relevant metrics. The Pay Governance research also indicated a significant increase in environmental metrics being used in 2021 relative to 2020, likely reflective of increasing community expectations.

Manager insights

We surveyed a small subset of Australian equities managers to get their insights and observations on what Australian listed companies are doing when it comes to ESG-aligned incentives.

The metrics

The most common category of non-financial metrics in incentive structures falls under ‘social’, which includes measures focusing on employee engagement and health and safety. Governance, another common category, might be considered a traditional ESG metric and includes company culture and values, behaviour, compliance and risk, and board structure. These have appeared in incentive structures for some time, for example a measure of accidents and fatalities, or culture and employee engagement and are typically part of short-term incentives (STIs). However, there is evidence that this is evolving and companies are looking at how they can integrate newer ESG targets which relate to more recent emerging concerns around climate change, sustainability, and diversity – and align this to their long-term business strategies.

A clear point from the manager survey was that appropriate ESG measures or metrics were very company-specific and therefore how it might be aligned to incentives is a very company-specific decision - there is no one-size-fits-all approach that can be used.

The key challenges noted in the survey with aligning ESG targets with incentives are around measurement and time frame, where even long-term incentives, which might be assessed over three to five years, are still too short for certain ESG targets. Ideally, specific ESG targets are in place that make sense for the tenure of a senior executive, say four to five years. This is particularly true for climate change, which requires much longer-term targets, however we think establishing interim targets creatively, for example, could be a way to overcome this challenge.

Even with a high level ESG goal or ambition in place, the specific metrics being measured are also critical for alignment and a key point from survey respondents was that these needed to be clear and unambiguous. Possible metrics relate to the factors noted in table 1 and certainly the broad view from fund managers is that we have moved past a vague-sounding ‘improve ESG’ as a target. The ‘tone’ from the top of the company was also noted by fund managers as being a guide to how a company ultimately approaches its business sustainability in practice. It is broadly considered that companies with meaningful integration of material ESG issues tend to have strong governance and oversight of their business.

One fund manager’s research indicated that while 45% of the management teams it engaged with globally on executive compensation had ESG-related metrics, none of these metrics were formally recognised by ISS, one of the major corporate governance and proxy voting advisors.

The role of proxy voting advisors

Proxy advisors can help guide asset owner engagement and focus on ESG-related factors including climate change, board diversity and executive remuneration. They may also therefore help develop guidance for incentive structures aligned with ESG objectives. ISS was mentioned by a number of the managers surveyed. It is the largest proxy advisor and has a role in keeping companies accountable. Globally, ISS applies a common approach to evaluating social and environmental proposals, which cover a wide range of topics including consumer and product safety, environment and energy, labour standards and human rights, workplace and board diversity, and corporate political issues. While a variety of factors goes into each analysis, the overall principle guiding all vote recommendations focuses on how the proposal may enhance or protect shareholder value in either the short or long term. As well as governance failures, the Australian proxy voting guidelines includes points on board diversity and the quality of a company’s disclosure of economic, environmental, and sustainability risks and how it regards these risks.

Which companies do it better?

Trends suggest the number of companies incorporating ESG and other non-financial metrics is increasing. A PWC study quoted 80% of ASX 100 companies have ESG metrics in their bonus calculations, of which 30% include an ESG metric that is purely an environmental measure. This was reiterated through our manager survey, and it was noted those with the most to lose, for example carbon intensive companies, have made more progress in energy transition and applying relevant ESG targets and alignment in incentive structures. Survey respondents noted companies in sectors like mining, energy, and materials, where there are high emissions and ESG concerns around safety, are increasingly including sustainability metrics tied to carbon reduction goals or the transition pathway in incentive structures. Examples of companies that have lagged and still maintain short term incentives (STIs) driven predominantly by financial measures (such as net profits) were prevalent in the technology sector as well down the market-cap spectrum in small-cap companies.

The general view from the survey participants was that large-cap companies are better aligned than their smaller-cap company peers. This may come down to resourcing and managing these changes which includes greater disclosure. One manager noted small-cap companies tend to have strong, nearer-term growth ambitions and compensation is linked to this with less regard for non-financial measures.

Transparency

Transparency of the percentage weighting to ESG targets in incentive structures is another area of potential improvement by companies. Several managers noted there is typically no disclosure of the relative weight of ESG metrics versus other non-financial metrics, so it is difficult to judge how important ESG is and whether executive teams have met individual indicators or not.

Nonetheless, a key theme from the manager survey results was that engagement with companies on ESG metrics in compensation has increased. One manager noted some companies claim that ESG is inherently incorporated in their compensation plans because ESG issues impact the fundamental financial performance metrics they use to determine pay outcomes. The Manager added it believes ESG factors shouldn't be sidelined this way and should balance financial performance metrics; however, others may think it is 'part of the job' and therefore managing ESG issues shouldn't be part of variable pay.

Stock examples

Rio Tinto and BHP have metrics linked to ESG, staff engagement, and health and safety. One manager noted there is the risk companies use ESG-aligned incentives as a fixed pay in disguise if metrics are not specific or challenging enough.

With regard to Rio Tinto, the company defended its decision to not strip long-term bonuses from three executives last year, including the chief executive, who left the company following community and investor backlash after the destruction of First Nations heritage sites at Juukan Gorge. One manager noted their culpability would have needed to have been proven for bonuses to be reduced or cut completely. An independent director from the company stated the board had to balance a number of factors and there “was no deliberate act or omission” or “fraud, malfeasance or cover-up”. This is probably a case where the failings should be considered ‘part of the job’ and it has since recognised that it “fell far short of our values as a company”. Rio Tinto first launched its sustainability strategy in 2018.

One surveyed manager noted BHP has done well with climate-related incentives and highlighted a number of improvements to its climate change governance in its 2020 Climate Change Report, which includes reductions in Scope 1 and Scope 2 operational greenhouse gas (GHG) emissions and short and medium-term actions to address emissions.

One survey respondent stated that as well as BHP and Rio Tinto; Origin, AGL, Woodside, Santos, and Oil Search all have metrics that are at least ostensibly linked to emissions reductions or addressing climate change. Other examples of climate-aligned linking included South32, which has sustainability as part of a balanced scorecard across emissions reduction, safety, health exposures, commercial investment and social impact.

In terms of long-term incentives (LTIs), AGL has an explicit metric while Endeavour Group is planning to make 20% of its LTIs subject to ‘responsibility’ metrics.

One of the managers added that Technology One, which has no ESG metrics contained in either STIs or LTIs, has at least defined ESG corporate objectives (contained in the company’s Sustainability Report and Corporate Governance Statement).

Another example of where measurements are difficult is with the banks. It makes sense there is alignment of senior executives to customer satisfaction; however, one manager noted (somewhat concerningly) the data can be bought or manipulated so this can be value destructive, so appropriate due diligence is critical.

Work in progress

One manager surveyed concluded that there are not many examples of where incentive structures are clear on the quantum of monetary incentive of meeting ESG targets, how they relate to the broad strategy, and what measures will determine success. Generally, the Australian market appears to be improving in this regard with the inclusion of climate-related measures in particular, but it is a work in progress.

The structure of ESG-aligned incentives

A broad theme from the survey responses was very clear; the inclusion of ESG metrics in the incentive structure can be a way of signalling to executives, employees, and other stakeholders the importance of ESG and can be a key way of integrating it into the corporate culture as it reflects what the organisation intrinsically values.

Underlying principles for ESG-aligned incentives structures

As societal expectations for the appropriate management of ESG risks increases, so too does the expectation from employees that the organisation they work for is aligned with managing ESG risks and opportunities. As this also becomes more important for employees, ESG-aligned incentives could even become a key tool in attracting and retaining staff.

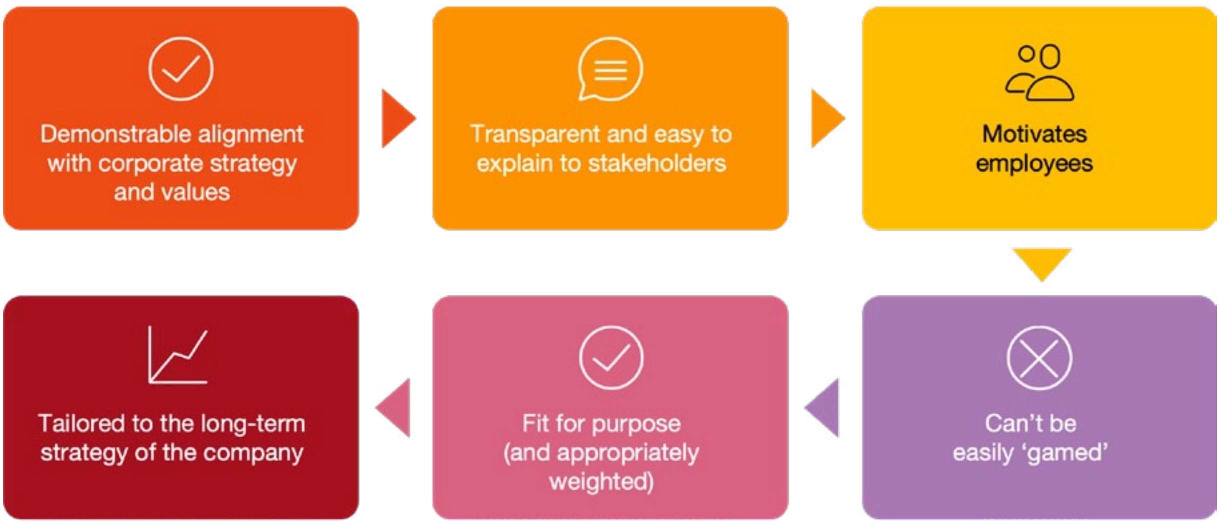
We think overall incentive structures should comprise both financial and non-financial incentives to motivate employees. The nature and scale of the incentives should logically be driven by the type of role but what is important to understand are the behaviours implicitly encouraged through the company's philosophy in developing that incentive structure. When it comes to structuring incentives, the devil is in the detail. To avoid it becoming a 'box- ticking' exercise, the weighting applied to ESG-aligned components of the incentive structure is critical, based on a range of different global studies this has been observed as being in the order of 15-20% of total compensation on average. To achieve the desired ESG outcomes, ESG-aligned incentives should avoid being ascribed an immaterial weighting in the overall incentive structure. Equally important is the avoidance of compensating executives for merely 'obeying the law' in the normal course of business.

"Remuneration policies are important incentives for achieving an organisation's goals and objectives and signal governance, oversight, and accountability for managing climate-related issues"

Task Force on Climate-related Financial Disclosures (TCFD).

As a general rule for incentives, we think the following principles are important:

Figure 2: Principles for incentives



Source: Frontier

A key element of effective ESG-aligned incentives is how they are structured. We think the following questions are worth considering when incorporating ESG-aligned incentives into remuneration structures.

Figure 3: Structuring ESG-aligned incentives

- What ESG metrics are most relevant to the company? (and how is it monitored, is it transparent)
- Does it link to the long-term business strategy?
- What percentage of total incentives are linked to non-financial outcomes? And what percentage of total non-financial outcomes are specifically linked to ESG-aligned outcomes?
- Will it form part of the STIs, LTIs, or both? How material is it?
- Does it imply certain ESG issues are more/less important to the company (is this reasonable/acceptable?)

Source: Frontier

Some ESG metrics have been a more common component of short-term incentives but this is starting to more commonly make its way into long-term incentive structures. We are starting to see additional ESG metrics considered (particularly those linked to managing climate change related risks), but this continues to evolve. Once the decision has been made to incorporate ESG-aligned incentives, appropriate, ongoing and relevant disclosure is considered a must, particularly for senior executives.

'Effective' ESG-aligned incentives are those that are fit-for-purpose for the company, they need to be relevant and appropriate to the nature of the company and its long-term strategy.

Based on our survey of Australian equities managers, there were some clear examples of effective and weaker alignment when it comes to ESG-aligned incentives.

Figure 4: Examples of effective alignment

Explicit, unambiguous, transparent and weighted long-term responsible/sustainability metrics, including some examples of these metrics being given greater weight over time

Integrating ESG metrics in short-term incentives (STIs) and long-term incentives (LTIs)

ESG targets integrated in the LTI framework through a LTI scorecard

Vested incentives to encourage long-term mindset

Clear link between business strategy and incentives, and what measures will determine success

ESG metrics included as part of a balanced scorecard

Source: Frontier

Figure 5: Examples of weaker alignment

No ESG targets contained in the STIs or LTIs and/or afforded an immaterial weight

No defined ESG-related objectives in the business strategy

Incentives driven solely by financial metrics

Incentives driven solely by financial metrics

Source: Frontier

The above lists are not exhaustive but provide some insights into how incentive alignment can vary across companies.

Critical elements for ESG-aligned incentives include what role the Board is playing in structuring compensation; how the company strategically approaches sustainability; and clear, unambiguous and transparent ESG goals and metrics that are fit-for-purpose.

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The final word

Companies and remuneration committees now face the challenge of navigating the path of meeting ESG objectives and aligning management. Companies in Australia have, for a long time, measured safety metrics, employee engagement and culture, but climate change and sustainability are newer factors to consider, and aligning pay with targets relating to these factors has challenges with metrics and time frames. Over the long-term there may not be a trade-off between ESG and long-term shareholder value, however, it is clear incentive structures need to discourage short-term decisions which might be good for short-term financial outcomes while harming the longer-term sustainability of the business.

Aligning executive incentives to ESG objectives has been embraced by the Australian market in-principle, strongly encouraged by the investment community through engagement as well as regulatory bodies, despite a more nascent policy framework relative to global peers. Further, the efforts in integrating ESG-related metrics into executive incentives is viewed to demonstrate a company's commitment to a sustainable business over the long term. However, implementation hasn't been consistent, varying by sector and market capitalisation. The ESG link is typically in the STIs and it is currently only afforded a small percentage of total remuneration, typically undisclosed, amongst other non-financial incentives. The skew to longer-term incentives may grow over time as boards become more comfortable that ESG metrics can be effectively tracked over the long-term and there is greater acceptance of an appropriate framework.

This is an evolving area; some progress has been made but it is still very early days. Approaches vary amongst jurisdictions (some are driven by regulation; while others are driven by community expectations), but there is currently no universally accepted approach which remains an impediment. There is some reluctance from companies given the nascent and still developing nature of ESG-aligned incentives which is a material change to traditional incentive structures. In principle, ESG-aligned incentives make good business sense but getting the structure right is key. We think this is an area that is likely to continue to evolve over the near term, both in Australia and globally.

Call to action

We think ESG-aligned incentives are a positive way to achieve strategic ESG objectives and it is positive to see companies increasingly integrate ESG-aligned incentives into their remuneration structures. Getting the structure right is a critical element, not only to help the company achieve its strategic objectives but to also avoid it becoming a box-ticking exercise. As an investor, understanding the structure and receiving appropriate transparency to assess and engage on ESG-aligned incentives is important and we think this will be an increasing area of focus.

Transparency is also one of Frontier's eight key culture principles we actively seek. We believe managers (and companies) who have nothing to hide ought to have a natural motivation to openly share relevant information with researchers. An aversion to such transparency is likely to be motivated by those seeking to hide unsavoury or unflattering information.

Given ESG-aligned incentives remain an evolving area, with no formal regulation or universally accepted framework, engagement is a key tool for investors. Engagement may be via proxy voting and proxy voting advisors, or directly with the company (or fund manager) as appropriate. This is an area Frontier is applying greater focus as part of our ongoing manager research, evolving our approach to engaging with fund managers in this important area.

As a general rule for incentives, we think the following principles are important:

Figure 2: Principles for incentives

Source: Frontier

What will Frontier do?

Frontier will continue to engage with fund managers on how they are integrating ESG into their portfolios as well as their engagement with companies. Earlier this year, Frontier introduced a more comprehensive ESG scorecard to better assess managers' approaches to ESG and distinguish between true integration and merely marketing/greenwashing. Key areas of assessment include governance, resourcing, integration, engagement, climate change and reporting. The scorecard will help clients make more informed decisions between alternative investment products and better assess which managers will help them to meet their own climate and other ESG targets.

What can clients do?

Clients can also continue to engage with their underlying fund managers regarding ESG integration in their process. In addition, where there is the opportunity to directly engage with companies, clients can continue to analyse and assess which companies are transitioning towards meeting aligned targets, preferably science-based, and how aligned senior executives are to these targets.

1. *Principles for Responsible Investment (PRI), "ESG-linked pay: Recommendations for Investors", 17 June 2021, https://www.unpri.org/executive-pay/esg-linked-pay-recommendations-for-investors/7864.article.*

2. *Australian Prudential Regulation Authority (APRA), "Draft CPG 229 Climate Change Financial Risks", April 2021, https://www.apra.gov.au/sites/default/files/2021-04/Draft%20CPG%20229%20Climate%20Change%20Financial%20Risks_1.pdf.*

3. *J Ellerman, M Kesner and L Ringlee, "Inclusion of ESG Metrics in Incentive Plans: Evolution or Revolution?", 16 March 2021, https://www.paygovernance.com/viewpoints/inclusion-of-esg-metrics-in-incentive-plans-evolution-or-revolution.*

4. *J Ellerman, M Kesner and L Ringlee, "Do UK and EU Companies Lead US Companies in ESG Measurements in Incentive Incentives Plans?", 2 June 2021, https://www.paygovernance.com/viewpoints/do-uk-and-eu-companies-lead-us-companies-in-esg-measurements-in-incentive-incentives-plans.*

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