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Opinion

Variable Executive Compensation and ESG: Still A Long Way to Go

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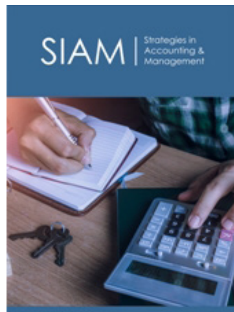

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Opinion

Integrating Environmental, Social, and Governance (ESG) criteria into executive compensation policies has become a hot topic in corporate governance in recent years, after various public polemics (e.g. Renault, Stellantis). In this context, many of the biggest companies have decided to regulate their C-suite and top executives' remunerations, according to disclosed principles that follow the values these companies are promoting. However, a detailed analysis of the CAC 40 companies shows we are still far from achieving meaningful integration. This article proposes to explore the current landscape, identifies key deficiencies, and suggests possible improvements. In theory, ESG criteria in executive compensation should incentivize leaders to align their decisions with sustainable business practices. If research indicates that companies incorporating ESG metrics in compensation packages do see a positive correlation with ESG performance, this practice remains inconsistent and often lacks depth. The European Corporate Sustainability Reporting Directive (CSRD) has aimed to increase transparency and accountability by requiring companies to disclose their ESG impacts. Despite these efforts, many companies still struggle to establish effective, standardised ESG frameworks that can be universally applied.

One of the main issues is the absence of standardised ESG criteria. The lack of uniformity results in a patchwork of approaches, making it difficult to compare companies and assess the effectiveness of their ESG integration. While environmental criteria are often prioritized, social and particularly governance aspects tend to receive less attention, resulting in a skewed application of ESG principles. Moreover, the discretionary nature of these criteria in executive compensation packages can be problematic. Often, ESG targets are included to embellish compensation packages rather than to drive substantial non-financial performance. This approach risks reducing the credibility of ESG initiatives, as executives might meet only the minimum requirements to secure bonuses rather than strive for genuine sustainable improvements.

To address these issues, we proposed that companies adopt a more tailored approach. As each company operates in a unique context with specific non-financial challenges, we think ESG criteria must be customized to reflect these individual circumstances. This not only aligns executive incentives with the company's broader sustainability goals but also ensures the relevance and impact of ESG targets. Promoting a philosophy of non-financial performance within executive compensation is crucial. This involves developing a set of principles to guide remuneration committees in selecting, assessing, and measuring ESG criteria. Moving beyond compliance to a philosophy where ESG performance is seen as integral to overall business success is therefore necessary, and what the authors of this article are in favor of.

Shifting from a "comply" to an "explain" approach is another significant change that could drive meaningful progress. A compliance-based model often results in a tick-box mentality, where companies adhere to minimum requirements without genuinely engaging with ESG principles. An "explain" approach, on the other hand, encourages companies to justify their

ESG criteria and how these align with their strategic objectives and operational realities. This model fosters transparency and accountability, as companies must provide detailed explanations for their ESG-related decisions. It enhances stakeholder trust and demonstrates a commitment to authentic sustainable practices. Additionally, it allows for flexibility and adaptability, enabling companies to modify their ESG strategies in response to evolving challenges and opportunities. Embracing a renewed philosophy of non-financial performance means recognising that ESG criteria are not merely adjuncts to financial performance but integral components of overall business success. Integrating ESG criteria into executive compensation should be seen as a legitimate goal, equivalent to financial objectives. By incentivizing executives to achieve non-financial performance, companies can align their sustainable value creation objectives with executive remuneration. This alignment can drive long-term competitiveness and resilience, which are essential in today's rapidly evolving business landscape.

Conclusion

As a conclusion, the journey towards effectively integrating ESG criteria into variable executive compensation is ongoing. The current practices within CAC 40 companies show some progress, but significant challenges remain. A more individualized approach tailored to each company's unique context is essential. Additionally, shifting from a compliance-based model to an "explain" approach can enhance transparency and accountability, fostering genuine engagement with ESG principles. Ultimately, embracing a philosophy of extra-financial performance within executive compensation can drive meaningful change. By viewing ESG criteria as central to value creation, companies can ensure that their sustainability goals are not only aspirational but also achievable and impactful. The road ahead may be long, but with the right strategies and commitment, the integration of ESG into executive compensation can become a powerful tool for sustainable business success.

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