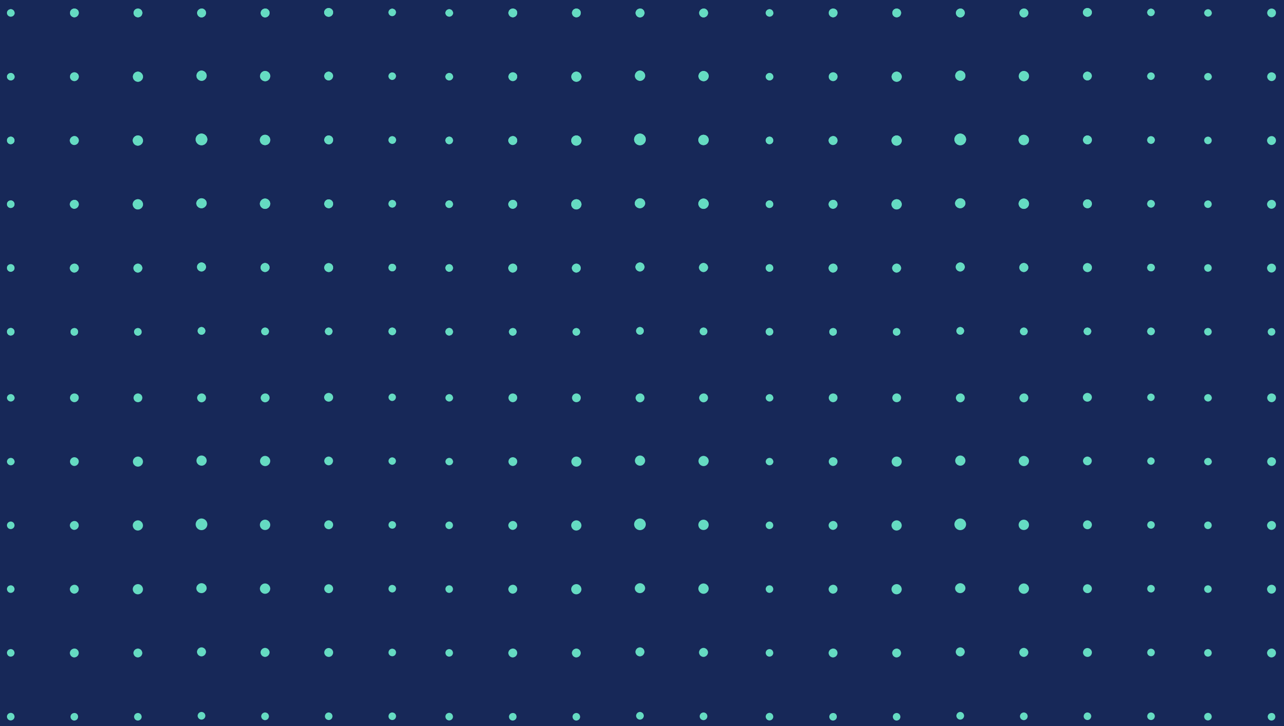
UC Berkeley
Center for Law and Business

Is ESG-Linked Executive Pay Driving Real Change?

Event Recap



December 11, 2024

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On December 11th, the Berkeley Center for Law and Business hosted a webinar in its"The Buzz w/ BCLB" series, exploring the question: Is ESG-Linked Executive Pay Driving Real Change?

Speakers: Robert Bartlett, Professor of Law and Business at Stanford Law School and faculty co-director of the Arthur and Toni Rembe Rock Center for Corporate Governance, Adam Badawi, Professor of Law at the University of California, Berkeley School of Law, Mark Rosen, managing director and consulting team leader at Pearl Meyer, and Drew Hambly, head of Stewardship at CalPERS, shared their insights on executive compensation.

Underlying Research—ESG Overperformance? Assessing the Use of ESG Targets in Executive Compensation Plans

In setting the stage for the conversation, Bartlett and Badawi introduced their research on ESG-based compensation among publicly traded companies in the U.S. They studied the executive compensation plans adopted by the S&P 500 firms and documented how often executives miss, meet, or exceed the financial and ESG-based targets outlined in these programs.

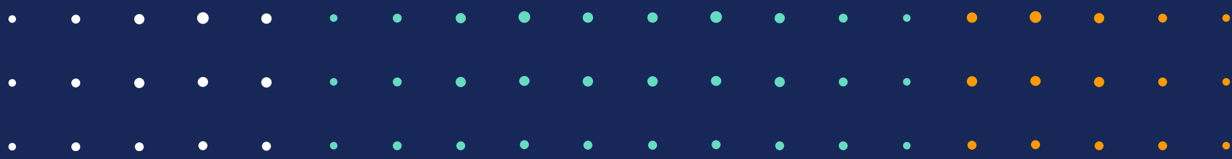
Three components make up a typical executive compensation plan: salary, annual bonus, and long-term incentive consisting of stock units and stock options. In the 2023 proxy season, the percentage for each is approximately 10% salary, 18% bonus, and 72% long-term incentive.

Executives are expected to hit a certain target to receive the full amount of the allocated compensation. If their performance exceeds that target by a certain amount, their respective compensation will rise by the same percentage until it reaches the agreed maximum.

Companies do set ESG targets for their executives, but it is yet uncertain how this trend will develop in the future. 315 of S&P 500 companies use ESG performance measurements in their executive compensation plans. Out of these 315 companies, 304 of them link ESG targets to the bonus section of executive compensation. In total, the ESG target accounts for 15% of the weights in the bonus and just 3% of the CEO's overall potential compensation.

Taking a further look, Badawi and Bartlett set out to answer how likely it was for executives to achieve their ESG targets. For the companies that set ESG goals, 203 of their executives exceeded their financial targets, whereas nearly a third of them missed every single component of their financial targets. This meant that financial targets were set so that they were difficult to achieve. For ESG targets, however, only less than 2% of the executives from these same companies failed to meet every single ESG target, indicating that ESG goals were structured to be more attainable.

ESG target appeared to be a "participation trophy", said Badawi. As ESG performance only makes up 3% of executives' compensation, ESG targets are not likely to effect change. In addition, low ESG targets suggested weak executive compensation committees, said Hambly.



Facing significant shareholder pressure, boards likely rushed to include ESG targets in executive compensation plans without thinking it through.

ESG Performance Metrics

Corporations take drastically different metrics to measure their executives' performance in terms of ESG. Some set a verifiable target such as reporting DEI targets to the Equal Employment Opportunity Commission (EEOC). Others do not have any clear targets and rather have their ESG board decide whether the ESG target is met. Objective, clear metrics may be helpful especially when a corporation already has a well-defined goal in mind, said Hambly. Firms might want to first make an ESG promise for investor relations purposes and then set a verifiable target to their executives so that the latter are constantly reminded of the ESG target.

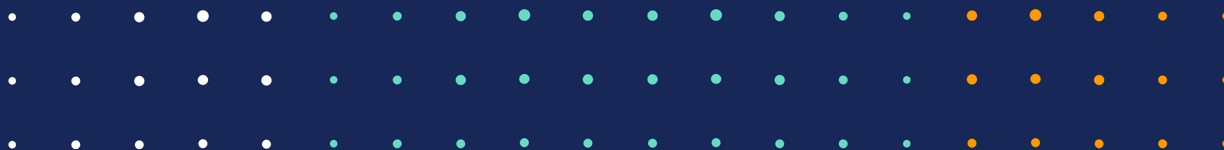
Overall, boards should aim to establish objective targets so that executives know what to work for, but this is not absolute. ESG committee members can measure executives' performances while taking into consideration the events of the year. Unlike hard, fixed numbers, committee members are better capable of offering a more comprehensive evaluation of the executives' contributions. Companies can also avoid publishing their specific ESG targets for trade secret purposes if they just let the board determine whether ESG targets are met.

Are ESG Targets Set Too Low?

The conversation then delved into whether the ESG targets were being set at overly modest levels. Hambly echoed the conclusion that the current ESG performance was a participation trophy. The underlying research could better measure the effectiveness of corporations' ESG targets if conducted over a ten-year period. Nevertheless, if executives were always exceeding their set targets, companies were setting the targets too low.

Rosen provided more insights into the design of executive compensation packages, highlighting the categorical differences between financial and non-financial metrics, such as ESG performance. Financial metrics are used in long-term incentive plans that form the majority of executives' annual compensation. Executives can receive up to 200% payout for exceeding their financial targets due to the latter's volatility. In a bad cycle, they might also just earn close to zero.

On the other hand, executives typically expect to get paid "somewhat near target" for non-financial performances. Companies do not tend to put non-financial metrics in long-term incentive plans. Without a clear numerical goal, non-financial metrics trigger "variable plan accounting," which would be an issue as companies prepare their earnings statement. Even with a clearly set numerical goal, companies still loathe to put ESG targets in CEO's long-term incentive plans because it is virtually certain that CEOs will hit those goals faster than planned.



Compensation committees also tend to spend a lot less time developing these non-financial performance metrics. As a non-financial metric, therefore, ESG targets are almost binary: executives either hit the targets or not.

As of right now, there is no defined roadmap to include ESG targets in long-term incentive plans. Non-financial metrics tend to vary across industries. For instance, while safety might be a key concern in construction, it may not hold the same weight in other sectors. As executive compensation committees face pressure to implement ESG targets, they make up rough measurements based on shareholder reactions and the message they want to convey to the corporation.

Although little financial incentive is provided for executives to push the ESG agenda, Rosen held that placing ESG as a factor that impacted executive compensation would still remind executives of its importance. The compensation board does not intend to make ESG targets so low that executives get paid as if it is a salary. However, the board also needed to make sure that executives were getting paid market rate to avoid getting poached, said Hambly.

Why Shareholders Would and Should Care about ESG

The webinar also discussed whether shareholders should care about ESG compensation. Long-term shareholders ought to take a wide portfolio perspective. Instead of focusing on earnings and profits of the given year, an asset owner who plans to hold on to an asset for decades must treat long-term ESG issues seriously.

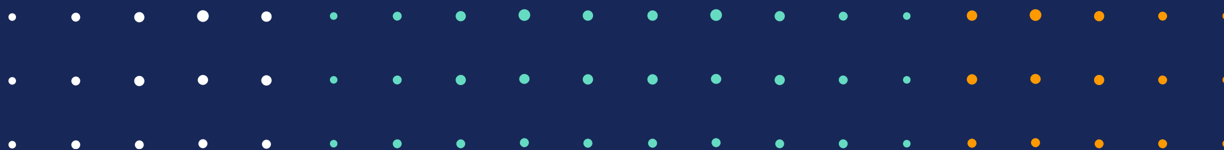
An unstable environment impacts one's returns and ability to pay pensions. If no attention is paid to ESG issues, then the collective action problem would mean that all who traded in the market would suffer from its instability, said Hambly.

Despite this awareness, not all shareholders would like to see ESG targets in executive compensation plans. While ESG might be important, companies might not have to pay for them. Rosen held that one does not need an incentive plan to get good ESG performance. "The vast majority of executives don't do things because they would get paid in their incentive plan", said Rosen. Executives have the motivation to think about the long-term sustainability of their company: it boots company earnings, to which the major portion of their compensation is tied.

Board members, whose tenure are twice as long as an average CEO, also play a key role in encouraging long-term thinking as they interact with shareholders.

Issues with the Current Executive Compensation Plan

The conversation moved on to cover challenges in the current executive compensation plans. CEOs receive roughly $1 million in salary, a 12% annual incentive plan, and long-term incentive awards. Jack Welch, one of the best CEO of the 20th century, is just getting the medium pay for an S&P 500 CEO after inflation.



A statistical explanation for the serious pay inflation is that the median increases whenever every tries to achieve the median. As boards would generally like to pay a well-performing executive team above the median, a sheer increase in executive compensation is almost unavoidable.

"If I could start from scratch and redesign the current executive compensation plan, I would", said Hambly. Many CEOs receive performance stock units (PSU) with a three-year investing period as part of their compensation. Under this regime, a CEO gets a share of the stock but only earns it if they achieve some sort of financial target within three years. However, many criticize that the performance period is too short and could restrict CEO performance. CEOs with unrealistic financial targets might also give up this portion of their compensation and choose not to invest in the company stock at all. Though there is no one-size-fits-all solution, Hambly suggested paying executives with performance stock units (PSU) with longer vesting periods and adding some holding requirements.

Nevertheless, with the presumption that most CEOs want to do a good job and build a lasting business, most boards would pay them decently, and pay inflation still seems inevitable.

Is Removing the Entire Non-financial Performance Metric Possible?

When Boeing had to let go of their CEOs, the latter got millions for their go-away payouts whereas the company suffered, with stock price down by more than half.

The current performance metrics system is designed to prevent this issue: by setting performance targets, CEOs cannot get a certain amount of compensation without having met their targets. In a certain way, the proposed attempt has already been made. And yet, it has not been very effective.

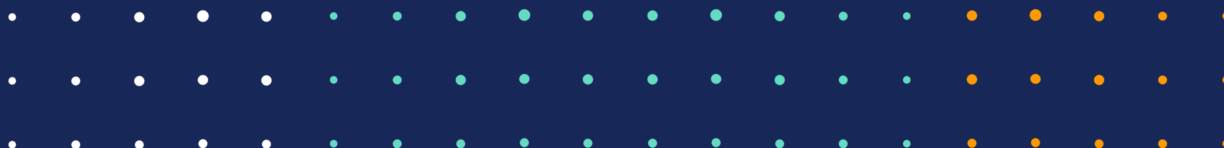
Peer Group Performance Metric

The webinar also discussed how peer group performance metric is used for long-term incentive awards. Executives' performances are evaluated based on that of the other peer companies. Executives receive adequate compensation when their stock price is above the median of the peer companies. Compensation committees are pushing back on this tradition by demanding performance over the 55th percentile, but the future trend remains uncertain.

Cherry-picking poor performance companies is of major concern when peer group performance metric is used. Rosen suggests two methods to police against cherry-picking. First, using an index with a broad enough group would generate a fairer peer group. Second, if executives consistently outperform the group, the latter is somewhat biased.

The Current ESG Outlook

According to Bartlett, DEI movements have reached their peak in 2024. Whereas many companies want to represent their clients' community, they might be more reluctant to put it in their incentive plan in the future. With political pushback from the Supreme Court cases last year, compensation boards will lessen disclosure to avoid lawsuits.



Companies do experience short-term reductions in sales when they do not make a solid commitment to DEI. Whereas some companies used to be scared of a PR backlash, Hambly predicted some reduction in their impact in the future. Influencers even purchase company stock so as to gain access to corporate proxies and push for ESG agenda. Boards would react to practical advice such as setting a clear, verifiable ESG target. And yet, Rosen noted that the majority of influencers failed to deliver such advice and thus received limited attention.

On the other hand, firms' commitment in other ESG areas such as safety and governance would not decrease in the future. Corporations will adopt better accounting, and a deeper understanding of carbon emissions and develop concrete roadmaps to achieving their goals.