ESG & Executive Compensation in 2021

Driving ESG and corporate strategy with executive pay.

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LANE CAPUTO

COMPENSATION

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EXECUTIVE **SUMMARY**

The extent to which organizations are perceived to be responding to Environmental, Social, and Governance (ESG) issues is becoming increasingly important to various stakeholders. This perception can impact the view of the organization and its sector, its impact to the 'social good', and generally the concept of whether an organization has earned its perceived license to operate.

Just as important for many companies, the world's largest institutional investors are increasingly scrutinizing their investment strategies and assessments of risk versus return through an ESG lens. As the investment community's focus on ESG intensifies, companies' relative responsiveness to ESG concerns will create winners and losers in the competition for progressively choosey capital.

The influx of retail and institutional investment into sustainable funds has increased materially over the past several years. To further underpin this shift, institutional investors have been dramatically escalating their engagement efforts with the companies in which they invest to accelerate the focus of these companies on addressing ESG issues. In turn, management teams and boards of directors must devote time and resources to respond to the growing chorus of demands for increased analysis, measurement, disclosure and mitigation of ESG risk into their companies' business planning cycle.

If ESG issues will be playing a larger role within corporate strategy, should ESG targets – and performance against those targets – not also play a larger role in executive pay programs? We are seeing a growing consensus that these two topics should be more closely intertwined.

Focusing on the mining sector, the findings in this report show that both the tracking and reporting of ESG metrics and the integration of these metrics into executive pay plans are in their infancy. With that said, the extractive industries in general and the mining sector specifically, have a head start in many aspects of ESG tracking and reporting via their historical focus on both Health, Safety & Environment (HSE) and community relations within their operations. With this historical focus on many elements of ESG, albeit by another name, and a strong governance foundation initially developed to ensure fiscal and reserves reporting, the mining sector is well-positioned to more fully integrate ESG performance into executive pay programs.

WHY COMPANIES SHOULD **CARE ABOUT ESG**

While mining organizations will always be measured according to their financial and operational success, we are now entering an era whereby the sustainability of this financial and operational performance (and, therefore, the very market value of a company) is being calculated with an eye on an organization's identification and mitigation of the ESG risks that it faces now and in the future.

A discussion of ESG and its risks is really a discussion of governance as all aspects of the ESG spectrum fall under the broader umbrella of the board of directors' oversight of risk and the sustainable business practices that will ultimately deliver sustainable financial returns. One can easily see from sample topics listed in **Table 1** below that all ESG factors are equally important in building and maintaining a sustainable business and companies have been successfully managing many of these ESG topics for decades.

Most recently, certain Social and Governance (e.g. gender & diversity, board composition) and Environmental (e.g. climate change) initiatives have been at the forefront of the ESG discussion. For the extractive industries in particular, the focus on climate change and other Environment aspects of the ESG spectrum are being weighted more heavily by ESG standard setters (e.g. Sustainability Accounting Standards Board [SASB], Task Force for Climate-Related Financial Disclosure [TCFD]), asset managers and ratings agencies. Failure to adequately address the ESG concerns of asset managers and ratings agencies may soon impact the ability of companies to raise capital.

Some examples of ESG factors are listed in **Table 1** below.

Table 1: Examples of Environmental, Social, and Governance Matters

ENVIRONMENTAL	SOCIAL	GOVERNANCE
Climate change impacts and GHG emissions	Labour standards	Board composition
Energy efficiency	Human rights	Executive compensation
Renewable energy	Employee engagement	Executive succession planning
Air, water, resource depletion or pollution	Customer satisfaction	Audit committee structure
Waste management	Community relations	Bribery and corruption
Biodiversity impacts	Gender and diversity	Whistleblower programs
	Safety management	

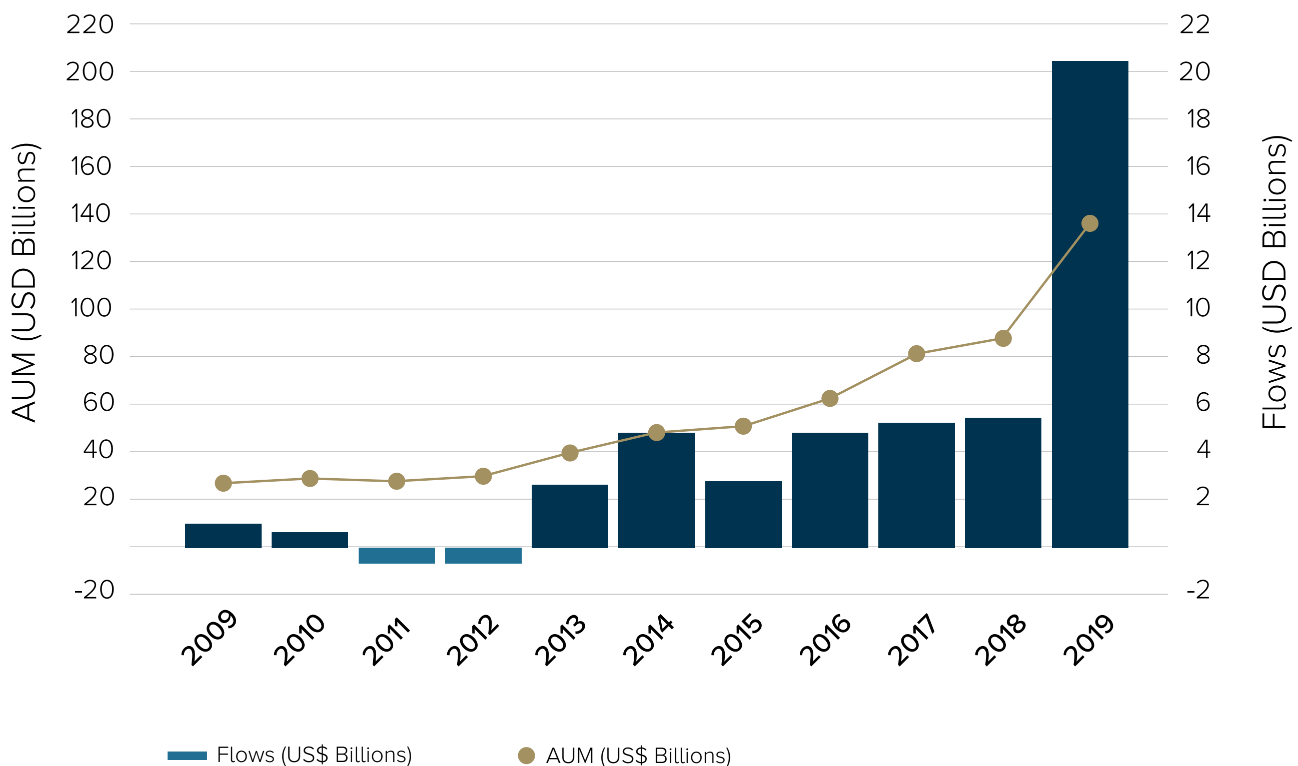
Source: *Adapted from GAO analysis of documentation from the CFA Institute, Sustainable Accounting Standards Board and Principles for Responsible Investing*

Moving towards Sustainable Investing

The rise of ESG concerns among investors is not a new phenomenon, but the topic has become more prominent in the eyes of both retail and institutional investors over the last few years. As shown in **Figure 1**, net asset inflows into sustainable funds in the U.S. totaled a record $USD 21.4 billion in 2019, up nearly 400 percent from the prior record set in 2018[1], and total assets under management (AUM) increased significantly to just under $USD 140 billion in 2019. Similarly, in Canada, funds invested in Canadian-domiciled sustainable funds in Q1 2020 eclipsed sustainable investment in all of 2019.[2]

"Net asset inflows into sustainable funds in the U.S. totaled a record $USD 21.4 billion in 2019."

Figure 1: Total Assets Under Management in US-based Sustainable Funds



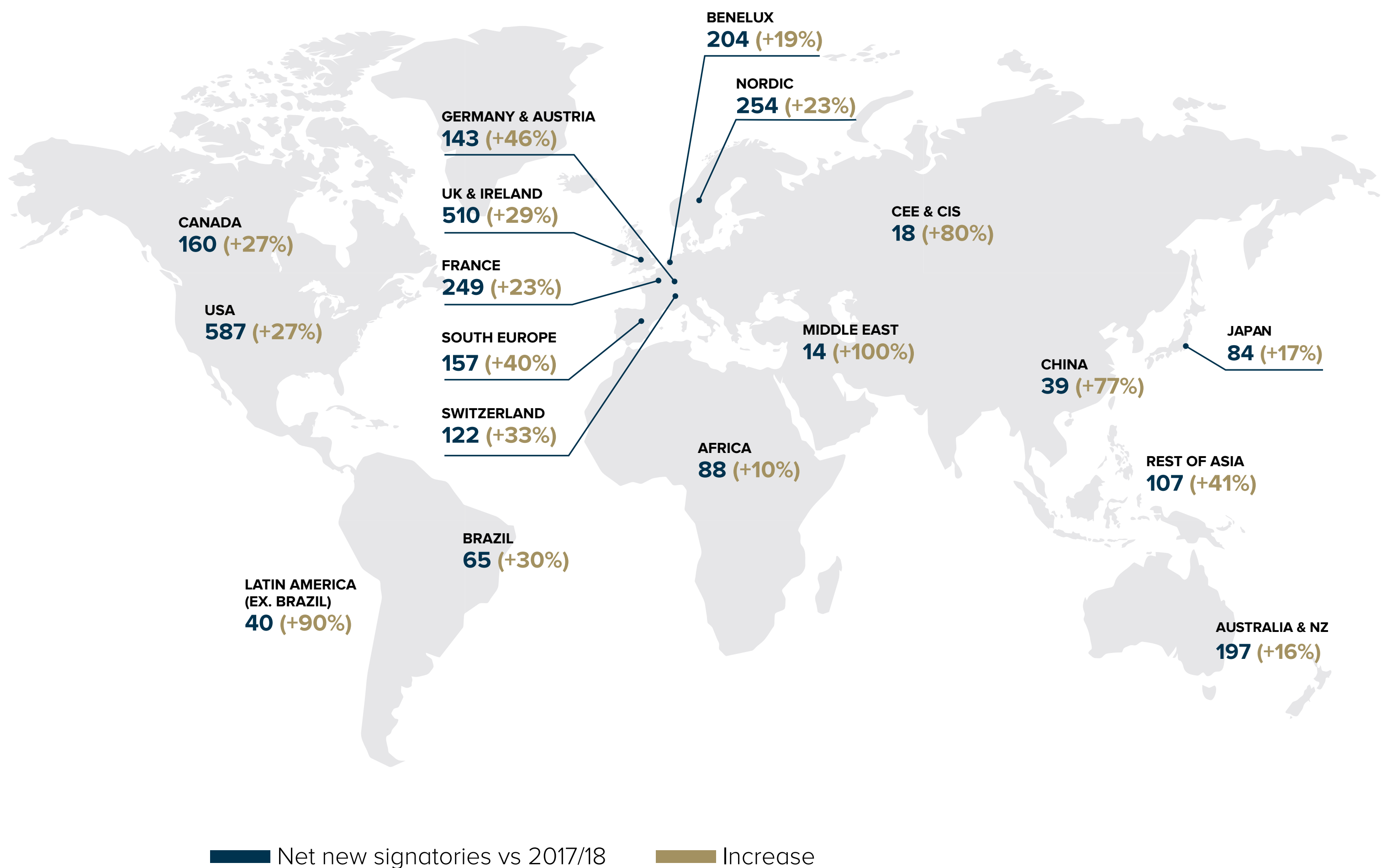
The world's largest institutional investors are responding to, or leading, the movement towards sustainable investing. Take, for example, the UN's Principles for Responsible Investment (PRI) which requires all signatories commit to incorporating ESG issues into their investment practices. PRI now has more than 3,000 signatories, representing $USD 103 trillion in AUM.

[1] Morningstar – *Sustainable Funds U.S. Landscape Report - February 19, 2020*

[2] Morningstar – *Canadian ESG funds grew faster May 7, 2020*

Or, look at the closely affiliated investor initiative Climate Action 100+, whose signatories aim to engage with the world's top greenhouse gas emitters to drive the clean energy transition in line with the goals of the Paris Agreement and the Taskforce on Climate-related Financial Disclosures (TCFD) principles. Climate Action 100+ now has 500 institutional investors representing $47 trillion US in AUM (see **Figure 2** below).

Figure 2: Climate Action 100+ Net New Signatories By Region



As of March 2020.
Net new signatures since 1 April, 2019

Source: *Climate Action 100+*

These investors, in their marketing material, proxy voting guidelines, and increasingly via direct engagement with listed issuers, have detailed the importance of measuring, reporting and mitigating ESG risk across investee companies' operations.

While there has been a significant increase in ESG-related shareholder proposals in both the 2019 and 2020 AGM seasons, many resolutions are being defeated at the AGMs. Not because there has been no movement on making the case for ESG reporting, but because the larger institutional investors have directly negotiated agreements with their listed issuers in line with their own sustainable investment criteria. Having secured commitments on ESG initiatives they support, these large investors often then vote against some of the more generic ESG resolutions from other parties.

The ESG risk to cost of capital also holds true for debt financing. As shown in **Figure 3,** Moody's credit ratings now include considerations for ESG risk.

Figure 3: How ESG Can Be Assessed To Inform Credit Ratings

Source: *Moody's Investors Service*

SUSTAINABLE INVESTORS **IN ACTION**

There are many investors active in the Canadian mining sector with clear sustainable investing guidelines. The guidelines of some of the more active asset managers in the sector have been outlined below. There has been a notable increase in focus on the Environmental category of sustainable investing in most asset managers' 2020 guidance, in line with accelerating climate change attention across the globe. The most frequently reported engagement topics from these asset managers over the past several years have been in the Governance category (board independence, term limits, diversity targets, executive remuneration); however, given the climate change focus of most of the guidance we have reviewed, we expect the Environmental category to see an increasing engagement focus moving forward.

BlackRock – Investment Stewardship Engagement Priorities for 2020

(PRI, Climate Action 100+ signatory; SASB and TCFD proponent)

"Management of climate and environment-related factors is an increasingly defining factor in companies' long-term prospects. We also believe that robust disclosure is essential for investors to effectively gauge companies' preparedness for environmental risks and opportunities. We are asking that by the end of 2020, companies issue reports aligned with the recommendations of the Sustainability Accounting Standards Board (SASB) and the Taskforce on Climate-related Financial Disclosures (TCFD). We will hold directors accountable if a company does not make adequate progress on such disclosures."

Fidelity – ESG Report 2020

(PRI, Climate Action 100+ signatory; TCFD proponent)

"For 2020, our climate priority will be to work with companies to disclose scope 1, 2 and 3 emissions (i.e. direct emissions from operating activities and energy use, and indirect emissions within value chains) and set measurable targets to achieve decarbonisation.

"We will also seek to engage on specific social themes such as employee welfare and to understand how companies are pivoting their business models towards greater social purpose. At Fidelity, we see better disclosure as fundamental to improving sustainability within companies. We take the opportunity whenever we engage with companies to recommend that they consider TCFD-aligned disclosure".

VanEck – Responsible Investment Philosophy

(PRI signatory)

"VanEck's approach to responsible investment incorporates Environmental, Social, and Governance ("ESG") responsibilities into its investment process. VanEck views ESG factors as fundamental and integral components of its active investment process and is committed to incorporating them, where possible, into its investment analysis, decision making and ownership policies.

"VanEck believes that it is in the interest of its clients to consider these factors when making an investment decision. It also believes that a strong or genuinely improving ESG record should translate into a company's differentiated financial performance and may have an impact on valuation. It further believes that companies exhibiting strong ESG practices will more likely be successful over the medium to long term."

Invesco – Investment Stewardship Annual Report 2019

(PRI, Climate Action 100+ signatory; SASB and TCFD proponent)

"Our ESG philosophy is based on our belief that ESG aspects can have an impact on sustainable value creation as well as risk management, and that companies with ESG momentum may present investment opportunities. We take our responsibility as active owners very seriously and see engagement as an opportunity to encourage continual improvement. During the one-year period ending June 30, 2019, our investment teams covered ESG topics in over 1,000 meetings with investee companies. This was an increase of 43 percent over the prior one-year period."

DETERMINING WHAT TO REPORT **AND WHERE**

Once an organization has determined that it wants to actively manage ESG issues, it is advisable to follow one (or two) of a multitude of ESG reporting standards to create a meaningful sustainability report that details your organization's actions to address ESG factors and impacts. Below we summarize three ESG reporting standards that have seen the most uptake from companies in the extractive sectors.

Global Reporting Initiative (GRI)

GRI outlines 34 topic-specific standards for sustainability reporting. Sustainability reporting, as promoted by the GRI Standards, is an organization's practice of reporting publicly on its economic, environmental and/or social impacts – positive or negative – towards the goal of sustainable development.

As one of the first sustainability standards created, GRI has a significant following; however, the investment community is rapidly switching focus to other standards (see SASB and TCFD below) which require stronger future commitments and goal setting versus simply reporting past information.

Sustainability Accounting Standards Board (SASB)

Created with significant input from capital markets participants, SASB assigns industry-specific reporting requirements to companies operating across a possible 26 primary industries - each having their own reporting standard. SASB requires organizations to disclose ESG risk and the strategies and targets employed to mitigate these risks. SASB standards are focused on the broad ESG spectrum and climate-related reporting under SASB is designed to work in tandem with TCFD.

Task Force on Climate Related Financial Disclosures (TCFD)

Created with input from the big accounting firms and other capital markets participants, TCFD reporting guidelines are specific to climate change-related disclosures and are designed to work in tandem with the broader ESG disclosure under SASB. The TCFD standard identifies several categories of climate-related risk and areas of opportunity across four broad disclosures: governance, strategy, risk management and metrics & measures. Disclosures include identifying risk – including the impact of regulatory changes - and setting, evaluating and reporting on targets (including the organization's strategic investment in green technology) designed to mitigate these risks to the company.

HOW THE MARKET HAS RESPONDED: **SUSTAINABILITY REPORTING IN THE S&P/TSX GLOBAL GOLD INDEX**

To investigate how Canadian mining companies have responded to stakeholder pressure to increase ESG reporting and mitigate ESG risk, we studied the ESG filings (i.e. sustainability reports) of the constituents of the S&P/TSX Global Gold Index. When reviewing these filings, we attributed metrics from each company's sustainability reports as either an Environmental, Social or Governance metric in accordance with the various stakeholder groups' (SASB, GRI, etc.) categorization of these metrics.

*For clarity in our analysis below, a **key performance indicator (KPI)** is the quantifiable measure used to track the performance of companies against an ESG metric over time (e.g. total recordable injury frequency rates, or "TRIF") and a **target** is the specific level of performance being strived for or the desired outcome against that metric (e.g. 'the company is targeting a TRIF of 1.3 for 2020').*

Our Findings

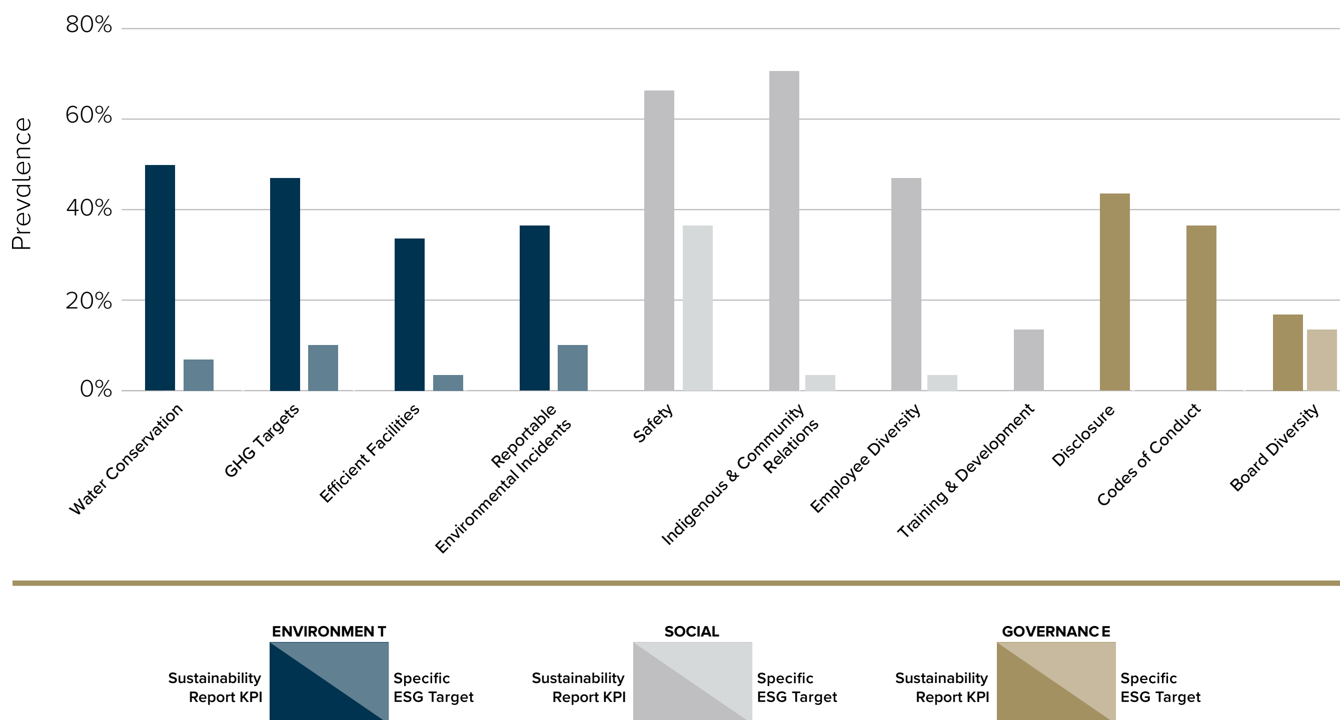
Eighty percent of the Global Gold Index publishes an annual Sustainability or ESG Report.

At 70 percent prevalence, roughly three times as many Global Gold Index companies use the GRI reporting standard for their sustainability reporting versus the next most-followed standards SASB (27 percent) and TCFD (23 percent). Note that many companies report in alignment with multiple standards and so overall prevalence will not add to 100 percent.

Unsurprisingly given the nature of the operations in the mining sector, Social and Environmental considerations are the most prevalent KPIs reported of the 11 major ESG categories below.

"Eighty percent of the Global Gold Index publishes an annual Sustainability or ESG Report."

Figure 4: Prevalence of ESG KPIs and Targets in Sustainability Reports
S&P/TSX Global Gold Index



There is a high prevalence of companies reporting and tracking ESG KPIs in sustainability reports, however, few provide specific targets for performance against these KPIs.

Indigenous and Community Relations and Safety are the most prevalent KPIs (70 percent and 67 percent prevalence, respectively) tracked in the sustainability reports, however, the sector's use of specific targets for these important measures is much less prevalent, with only 37 percent of companies also reporting specific safety targets in their sustainability reports and only one company, Barrick Gold, reporting a specific target for community participation levels in host countries.

Board diversity targets (13 percent of mining companies) and both GHG emissions reduction and reportable environmental incidents (10 percent of companies) are the next most prevalent ESG targets.

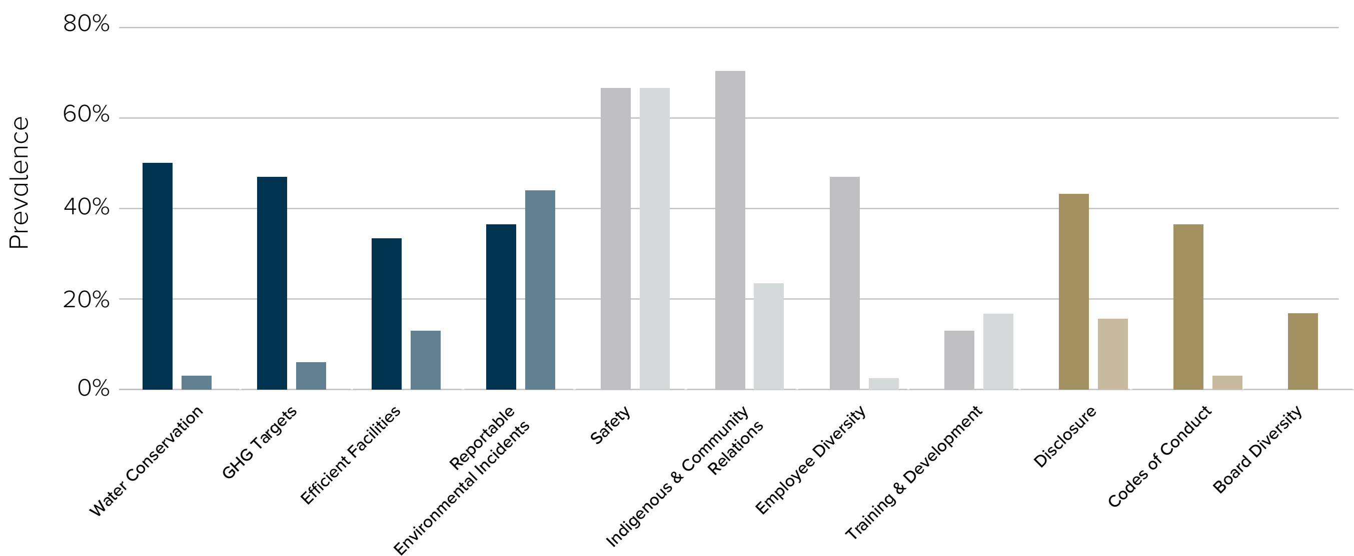
While the relative lack of specific target performance levels for most KPIs may initially seem surprising, as mentioned above, the majority of the index companies report in alignment with the GRI guidelines which require only that a company report on its economic, environmental, and social impacts, not that it set targets for changing these impacts.

EXECUTIVE PAY
AND ESG

As stakeholders' focus on ESG reporting has increased materially, so has the incorporation of ESG risk into companies' strategic planning processes in general. We next looked to see if there was any overlap between ESG reporting and tracking already being undertaken for sustainability reporting purposes and the ESG KPIs being measured by issuers in their executive pay programs.

As ESG becomes an increasingly important part of many companies' business strategies, executive efforts should be aligned with this evolving area of strategy. As with most key areas of business strategy, alignment of executives' efforts is facilitated (and communicated to stakeholders) via inclusion of ESG KPIs in executive incentive plans.

Figure 5: Prevalence of KPIs in Both Sustainability Reports and Executive Pay Plans
S&P/TSX Global Gold Index



This chart directly compares the prevalence of the same KPIs in both the sustainability reports and the variable pay plans of Global Gold Index companies.

Interestingly, existing executive incentive plan scorecards for the Global Gold Index companies include a broad range of ESG KPIs that are also addressed within these companies' sustainability reports. Notably:

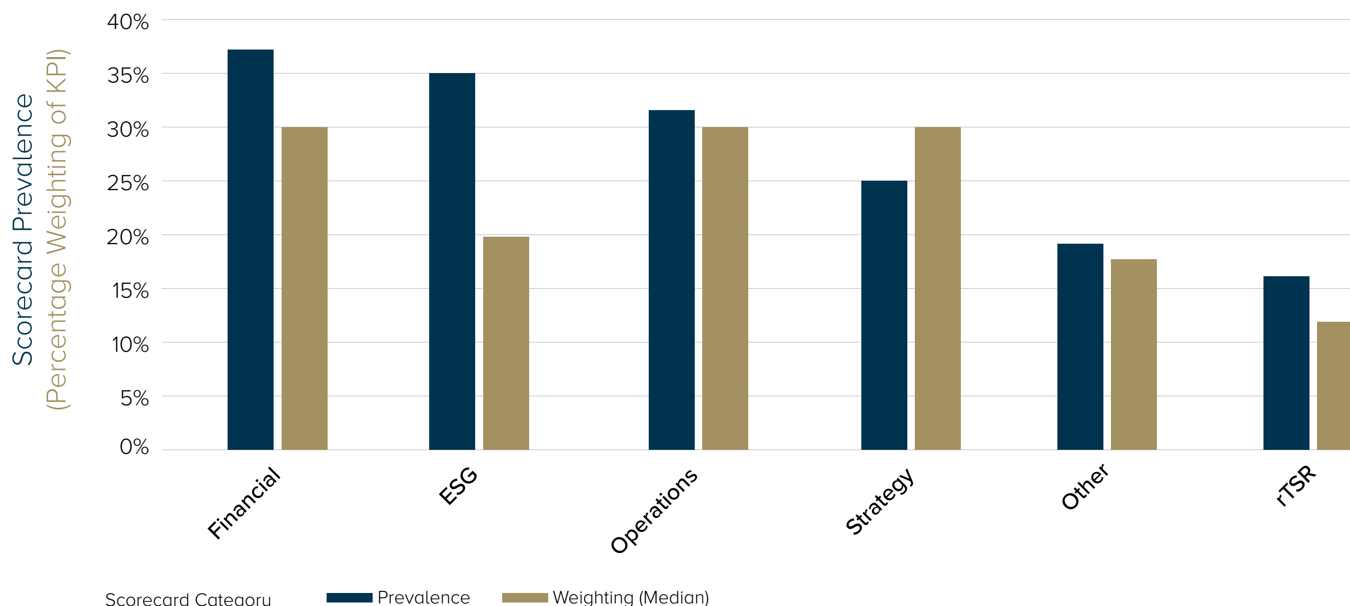
- KPIs within the Social category of ESG are the most frequently found in the executive incentive programs of the Global Gold Index companies. Sixty-seven percent of companies track and reward (or penalize) for safety performance at their operations, the same prevalence as the safety KPIs disclosed in sustainability reports. Unsurprisingly, most companies that disclose a safety KPI in their sustainability reports are the same companies that track this metric in executive incentive plans.
- Conversely, while Indigenous and Community Relations was the most prevalent ESG KPI tracked in sustainability reports (70 percent), only one company disclosed a specific target for this category in the sustainability reports and only 23 percent of companies use this KPI in their variable pay plans for senior executives.
- Other ESG metrics most impactful to the sector have also been included in executive pay plans, reflected by the prevalence of KPIs surrounding reportable spills, tailings releases, etc. in 43 percent of executive pay plans (versus 37 percent in sustainability reports).
- While 13 percent of Global Gold Index companies set a hard target for board diversity in their sustainability reports, there was no mention of board diversity in any executive pay plans. The absence of board diversity KPIs in executive pay plans is not surprising; diversity is a board of directors' mandate and not the purview of the management team.

The inclusion of ESG KPIs, especially those with a safety or environmental focus has been a fixture in the sector over the long-term; however, with the mounting pressure to report and mitigate ESG issues, how does the ESG weighting within scorecards compare to the weighting of operational and financial performance?

As seen in **Figure 6** (overleaf), although ESG topics are the second most prevalent short-term incentive (STI) scorecard metric, the ESG category is the fourth-highest weighted metric (20 percent weighting) in most of the Global Gold Index short-term incentive plan scorecards.

"KPIs within the Social category of ESG are the most frequently found in the executive incentive programs of the Global Gold Index companies."

Figure 6: The Prevalence of Categories vs. Their Weighting in the Short-Term Incentive Scorecards of Global Gold Index Companies



Also notable in our review of ESG metrics in executive pay plans is the relative absence of ESG KPIs in the long-term incentive plans of the Global Gold Index companies.

Only three companies specifically mentioned ESG (one specific measure of safety performance and two relatively generic mentions of sustainability) as being a consideration involved with the vesting of a portion of their Performance Share Unit (PSU) awards.

The longer-term timelines involved with material and continuous improvement in some ESG issues – e.g. GHG emissions reduction targets, water conservation, Indigenous engagement – combined with the strategic imperative with today's expectations to continuously improve in many of these areas, seems ideally suited to be measured over the timelines associated with longer-term incentive plans.

WHAT'S **NEXT?**

The rise of sustainable investment principles and most major asset managers' commitment to these principles means that ESG's place in corporate strategy and risk management should be receiving meaningful focus alongside financial and operational performance. As a fundamental contributor to economic success in a world focused on sustainable business practices, our question to companies is: should ESG performance not play a much larger role in executive pay programs and how do boards oversee the greater focus on ESG within these programs?

As the major capital providers to the sector increasingly align with sustainable investment principles, it is more important than ever for organizations to consider how they communicate their ESG strategy and achievements. While some progress has been made in ESG target setting and reporting across the mining sector, there is room to improve how these disclosures are positioned to investors and their advisors, and how incentive plans are aligned to reflect the importance of ESG to the future success of the sector in Canada and beyond.

"No longer can businesses take a 'wait and see' approach to ESG practices."

No longer can businesses take a 'wait and see' approach to ESG practices - the viability of the sector and of individual companies within the sector are dependent upon their thoughtful approach to this evolving area.

Lane Caputo is uniquely positioned to advise boards and their executive teams on communicating the importance of their organization's ESG strategy and performance to both internal and external stakeholders through the thoughtful inclusion of ESG within executive pay plans. Our trusted team of advisors have worked closely with boards and executive teams for years, providing advice on linking executive incentives to corporate strategy – expertise we know is required to ensure robust governance of ESG issues, maximize performance on targeted KPIs, and position ESG priorities with stakeholders while managing the unique risks and opportunities of the mining sector.

As 2020 draws to a close and we approach a new fiscal year, strategic plans will be revisited, and milestones and targets will be set for the year(s) ahead. No doubt ESG issues will figure more prominently in this business planning cycle than ever before. Please contact us to discuss how we can assist you in communicating your organization's ESG activities more effectively by thoughtful and strategic linkage to executive rewards programs.

Additional Reading

The most comprehensive view of all the stakeholders involved with the ESG movement that we've seen:

https://bit.ly/2K4kUi0

Larry Fink's 2020 letter to CEOs regarding the 'fundamental reshaping of finance':

https://bit.ly/3qAoBNt

Letter from the eight largest Canadian pension funds to Canadian companies regarding the adoption of SASB and TCFD:

https://bit.ly/33RPfYm

Lane Caputo Compensation Inc. is an independent executive compensation advisory firm specializing in guiding boards and leadership teams in linking their organization's performance - from strategy to execution - to executive compensation programs.

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