Chapter Zero New Zealand
The Directors' Climate Forum

Hosted by
Institute of DIRECTORS
NEW ZEALAND

Effective climate governance – remuneration and incentivisation

Incentivising climate-related targets and indicators in management remuneration

Thank you to Chapter Zero UK for their work in producing **Climate action and remuneration: A pocket guide for remuneration committees**.

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Remuneration and incentivisation

Incorporating environmental, social and governance (ESG) and climate-related factors into employee incentive schemes has become an increasingly important tool for supporting the focus on sustainable growth and long-term value creation, meeting increasing investor and stakeholder demands to demonstrate climate transition, and retaining and attracting top talent. This guide draws from conversations with remuneration/people and culture committee chairs, industry experts and national and international research to provide you with principles, guidance and actionable steps to support the inclusion of climate-related metrics within executive incentive schemes.

As boards increasingly acknowledge the need to integrate climate transition within organisational strategy, incorporating climate metrics and targets within executive remuneration is considered a critical lever to drive action and demonstrate accountability for managing risks and capturing opportunities. While there are mixed views about the value of incentives, if structured in the right way and linked to transparent, quantifiable and material metrics, they can help drive leadership behaviours.

The inclusion of ESG metrics in management incentive schemes continues to increase. While European companies are leading the way, an **analysis of incentive practices of the largest 264 Asia Pacific (APAC) companies by Willis Tower Watson (WTW)** revealed 77 per cent of companies included ESG metrics in management pay in 2023 (up from 63 per cent in 2022). Social metrics such as health and safety, workforce diversity, pay equity and customer satisfaction remain the key focus, however the prevalence of quantitative environmental and climate metrics is growing. In New Zealand, EY's analysis of its database shows that the prevalence of ESG measures in short-term incentives has increased from 38 per cent of organisations in 2021 to 53 per cent in 2023. Where ESG measures are in place in New Zealand, they focus on health and safety related measures (42 per cent of respondents).

Aligning management remuneration with ESG and climate considerations is an important lever to drive corporate strategy. While the prevalence of ESG metrics in long-term Incentive (LTI) plans has increased over the past three years, ESG metrics are predominantly focused on short-term indicators. This is perhaps because the linkages between shareholder value and ESG metrics over the longer term are not sufficiently understood. According to the WTW research, Europe has a significantly higher incidence of ESG metrics in LTI plans when compared to Canada and the United States (56 per cent versus 12 per cent and nine per cent in 2023).

An analysis of disclosures on ESG and the linkage to management remuneration of NZX50 companies by KPMG found a similar focus on short-term social metrics, particularly health and safety, and customer satisfaction. However there were a few companies with targets relating to sustainability, decarbonisation and emissions reductions. While being at an early stage, KPMG reported a significant increase in interest in ESG performance over the past two years, specifically tied to climate change.

"The board should ensure that executive incentives are aligned to promote the long-term prosperity of the company. The board may want to consider including climate-related targets and indicators in their executive incentive schemes, where appropriate."

– **Principles for Effective Climate Governance**

Remuneration and disclosures

Executive remuneration can be polarising and complex. However, with increasing scrutiny of executive remuneration and climate action, companies can explain the linkages between incentives and the need to respond to climate change/transition to a low-emissions economy. Further, comprehensive reporting on executive remuneration helps to build trust and confidence in companies, and there is an opportunity for companies to tell the story of how remuneration is linked to creating value by aligning incentives with ESG and climate-related metrics and targets.

The *NZX Corporate Governance Code* requires listed companies to have an executive remuneration policy that outlines the relative weightings of remuneration components and relevant performance criteria, noting that any performance-based remuneration should be linked to clear targets aligned with performance objectives. NZX recommends remuneration policies are published on the issuer's website and CEO remuneration is disclosed in its annual report. Specifically, it requires disclosure of base salary, short-term and long-term incentives, and performance criteria used to determine performance-based payments. NZX provided **new template guidance** on this in 2023.

The **NZX ESG Guidance** recommends listed companies provide non-financial disclosure, at least annually, including ESG factors and practices and how targets are measured.

Climate-reporting entities under the *Financial Sector (Climate-related Disclosures and Other Matters) Amendment Act 2021* are required to publish disclosures incorporating an overview of the organisation's governance oversight including:

- How the governance body sets, monitors progress against, and oversees achievement of metrics and targets for managing climate-related risks and opportunities, including whether, and if so how, related performance metrics are incorporated into remuneration policies
- Management remuneration linked to climate-related risks and opportunities in the current period, expressed as a percentage, weighting, description or amount of overall management remuneration

Records to demonstrate how the governance body is meeting these requirements could include the following:

- Process for developing and setting metrics and targets for climate risks and opportunities
- Information on performance against metrics and targets that relate to the management of climate-related risks and opportunities
- Remuneration policy that describes the climate-related performance metrics
- Employment contracts that describe the climate-related performance metrics
- Performance review reports that substantiate an employee's performance against climate-related metrics

The role of incentives in influencing behaviour

Remuneration and incentives have always played a key role in employee recruitment, retention, motivation and engagement. Linking remuneration to the achievement of climate and ESG metrics can play a pivotal role in influencing behaviour, and driving cultural change and individual choices that will help deliver organisational goals and objectives.

For organisations not subject to climate-related financial disclosures, the merits of linking ESG and climate objectives with management compensation are well established and support:

- Long-term prosperity and value creation
- Recognition of the need for climate governance and leadership from the board
- Transition to a low-emissions, climate-resilient economy
- Integration of climate change initiatives such as emissions reductions, opportunity identification, risk management and transition planning into strategy
- Evolving and increasing investor and stakeholder expectations of disclosure of meaningful targets
- Embedding of short-, medium- and long-term climate action throughout the organisation
- Attracting, retaining and engaging employees

Boards needs to provide strong leadership and take an active role in setting and monitoring ESG and climate-related targets. When engaging with stakeholders, the board needs to demonstrate the economic benefits of aligning remuneration with ESG and climate goals and the veracity of the measures and targets, so stakeholders have confidence that any outcomes-linked payments have delivered the appropriate returns. Alignment of ESG and climate goals with shareholder value is critical, particularly where the company may be seeking capital to support climate goals and objectives. Meaningful embedded climate action within management compensation frameworks can enable an organisation to deliver upon its climate goals and objectives.

Guiding principles for climate-related metrics

Starting with a clear set of principles can help remuneration committees to set climate-related metrics. Setting independently verifiable quantitative climate-related metrics underpins management incentive schemes and enhances transparency and accountability.

Principle	Guidance
Materiality	• Select metrics that are material to the business and aligned with long-term strategy – those that contribute to long-term value creation and systemic risk mitigation, and that are central to the climate strategy and transition plan • They must also be material to the individual participants in order to be effective in incentivising behaviour/action • Rationale for metric selection, and performance against goals should be disclosed • They must be of value to investors and stakeholders
Measurability	• Use robust metrics that can be reliably measured, quantified and scaled; potentially also allowing for independent assurance of performance achievement • This also allows for comparison across peers and industries, and tracking of meaningful progress over time • Climate metrics should be clearly differentiated from broader ESG metrics
Breadth	• Take a strategic approach to climate performance and measurement beyond simply capturing carbon emissions. Align metrics to the company's transition strategy and shareholder value • This could be measures tied to significant milestones, investments or innovation goals to support climate solutions or the company's transition plan • Enable ability to create or extend metrics to include climate-related nature, biodiversity in nature and a just transition • Metrics should be aligned to short-, medium- and long-term performance targets
Comparability	• Where possible and relevant, metrics should be defined using standard or widely adopted methodologies (for example, definitions validated by third parties for greater comparability). These might be industry specific • Climate metrics that are captured in ratings and indices published by reputable organisations are a good starting point
Clarity	• It is important to provide clarity, transparency and consistency as to the metrics used within management incentives schemes and their alignment with organisational goals/objectives • Seek independent assurance over the measurements • There needs to be differentiation between Scope 1, 2 and 3 metrics

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Step-by-step guide to embedding climate in management remuneration

The Climate Governance Initiative in association with WTW published the **Executive Compensation Guidebook for Climate Transition***. The guidebook and subsequent* **addendum** *published in 2023, provide a step-by-step guide for effectively embedding climate metrics and targets into management incentive plans.*

1 Integrate climate priorities into strategy

Integrate climate ambition and priorities into the company strategy and enterprise risk and opportunities framework.

2 Interim climate goals tied to the ambition and transition plan

Break down the climate ambition (e.g. net-zero by 2040) into short- and medium-term milestones as part of the overall climate transition plan, with clear roles and responsibilities outlined.

3 Involve the right stakeholders

Ensure knowledge exchange and decision making across Reward, Sustainability, Finance, and Risk on the right incentive metrics and design.

4 Select the right metrics

Considering impact on global decarbonisation and current incentive structures, select the right climate metrics.

5 Fit-for-purpose incentive design

Reference company climate key performance indicators (KPIs) and market practice to determine an appropriate and effective incentive design mechanism and formula.

6 Bring the remuneration committee on a journey

Given the relative nascency and challenge of the topic, engage and seek approval of the committee (and board) over multiple meetings and be prepared for an iterative process.

7 Tell the story with disclosures

Design and metrics selection should be disclosed clearly, showing alignment with strategy and other climate and ESG disclosures.

8 Evolve and learn over time

Review effectiveness and strategic alignment and adjust design, metric(s) and goal(s) over time.

The board's governance role is to maintain oversight and challenge management each step of the way, and ensure engagement of all key stakeholder groups.

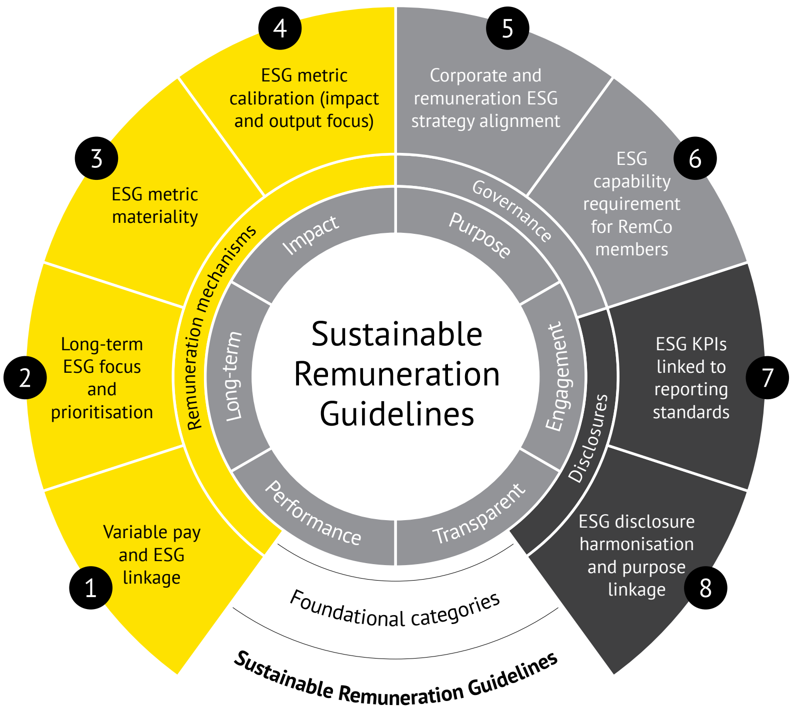
Figure: Step-by step guide to embedding climate in executive compensation. Source WTW, Executive Compensation Guidebook for Climate Transition 2023 Addendum

Incorporating sustainability into remuneration

While climate goals are generally long-term and the majority of an executive's remuneration is typically based on a short-term focus, setting interim, short-term targets that support long-term objectives provides ongoing accountability and incentivisation for employees. Accordingly, metrics need to remain flexible because they will continue to evolve to reflect changing strategic emphasis, increasing knowledge, shifts in focus and innovations. EY have developed Sustainable Remuneration Guidelines to enhance the linkage between sustainability, purpose and pay.

There are multiple ways sustainability can be incorporated into remuneration, such as:

1. Develop ESG KPI/metric materiality thresholds and select material ESG metrics to incorporate into variable pay programs – short-term incentive (STI) and long-term incentive (LTI) plans
2. Link ESG KPIs within variable pay either by means of balanced scorecards, multiplier or underpin/ threshold
3. Prioritise ESG KPIs within LTIs. Emphasise LTIs within executive remuneration mix to reinforce ESG's long-term and strategic implications
4. Establish short-term ESG KPIs that are based on output assessments in support of long-term ESG goals and KPIs that are based on impact assessments
5. Align corporate ESG strategy with total remuneration strategy to support organisational purpose and strategy
6. Prioritise ESG as a core competency for remuneration committee membership selection criteria
7. Align ESG remuneration KPIs/metrics with reporting standards to support transparency and comparability
8. Harmonise and simplify all corporate ESG disclosures and align with purpose (for example strategic, sustainability and remuneration reports)



Source: **Sustainable Remuneration Guidelines**, EY, 2023

Insights from New Zealand remuneration committees

A number of chairs of remuneration committees provided insights into the role of directors and incentivisation practices currently taking place to support climate action. Most acknowledged their systems weren't perfect but that it was important to take the first steps, knowing the measures would continue to evolve over time in line with the development of their reporting and disclosures.

Incorporating climate measures[1] into performance-based incentives supports the alignment of decision-making within organisational goals. Achieving this alignment is a key driver for achieving climate outcomes while preserving shareholder value. The types of incentives that can be considered include:

- Long-term incentives are set at the executive level (Tier 1 and 2)
- Short-term incentive schemes are generally open to a wider pool of staff
- Organisation-wide incentives such as implementing an internal price of carbon. Gamification/points and rewards programmes can also be useful tools to reduce greenhouse gas emissions and align decision-making across the organisation
- Climate measures within incentives schemes are generally tied to measures within existing frameworks – such as science-based target initiatives or sustainability strategies
- Climate measures can include:
  - qualitative and quantitative measures
  - emissions reductions
  - consideration of lifecycle emissions
  - increasing renewable energy demand/use
  - development of strategies or plans such as climate adaptation plan, waste minimisation strategy, biodiversity workplan
  - achievement of net-zero targets

"Including climate goals in KPIs and incentive plans helps 'bring to life' the organisation's sustainability goals."

"Having climate measures within our incentive plans provides confirmation that priorities at the top level are pointing in the right direction. Regular review of progress means the conversations happen frequently allowing plans to be adjusted if needed."

"Because sustainability is a key pillar of the company's strategy, it was decided to include measures within the company's short-term incentive scheme to communicate to our people the importance of the strategy and to track progress."

"The strong emphasis on climate and decarbonisation at the executive level means that these priorities are naturally reflected in the objectives, goals and KPIs used within teams."

1. Climate measures refers to any climate-related key performance indicators, goals, targets and/or achievements set.

Global trends

2023 confirmed a continued upward trend globally in companies employing ESG measures in executive compensation schemes. Despite the presence of these measures still being in their infancy, there are differences by region, sector, and company size.

Increasing allocation of ESG measures into LTI (long-term incentive) plans

While still minimal, the allocation of ESG measures in executives' LTIs is continuing to increase. GECN Group & Guerdon Associates found 90 per cent of large global companies have now adopted ESG incentive measures but these are predominantly incorporated within STIs (short-term incentive) plans. Only one-third (34 per cent) of companies use those measures in their LTI plans with South Africa, Europe and the United Kingdom showing the highest prevalence. These LTIs are most seen in the energy and utilities sectors. Australia's ASX100 has lagged its global peers in adopting ESG measures into LTI plans, stagnating for the past two years, with New Zealand further behind. Current LTI plans tend to reflect long-term targets of which reaching net zero greenhouse gas (GHG) emissions by 2050 continues to lead the way. Companies are seen to be breaking any long-term targets down, commonly into three-year goals to capture executives' tenure and highlight value for shareholders in the near term.

The adoption of ESG measures is increasing across a broad range of sectors

Increased adoption of ESG measures in incentives from the healthcare and information technology sectors was reported in 2023. This narrowed the gap from the early adopting industries such as energy (remained flat), financials and utilities. (WTW, 2023; GECN Group and Guerdon Associates, 2023). Arguably this recognises the increasing awareness of energy intensity in these sectors which reflects a greater focus on reporting and risk management/mitigation concerns.

Environmental measures within ESG compensation structures continues to rise

In 2023, among the suite of ESG measures used in executive incentives (social, environment, customer, governance, and community), environmental measures increased the most across regions. While Europe still leads against their global peers, Europe's adoption of ESG measures remained flat in 2023. Meanwhile, North American and South American companies showed high rates of adoption, particularly in the measurement of GHG emissions, perhaps due to the influence of extreme weather events (GECN Group and Guerdon Associates, 2023). Australia showed little change in its adoption of ESG measures. GHG emissions remain the most common type of environment measure, increasing by 31 per cent year over year, coinciding with companies setting emission reduction targets and disclosing them publicly. The difficulties with measurement and action on Scope 3 emissions still remain highlighting the challenge of having the right amount of realism and ambition in incentive structures. Both will need to be refined and better scoped, along with greater assurance, to be effectively used as a basis for remuneration and other incentives.

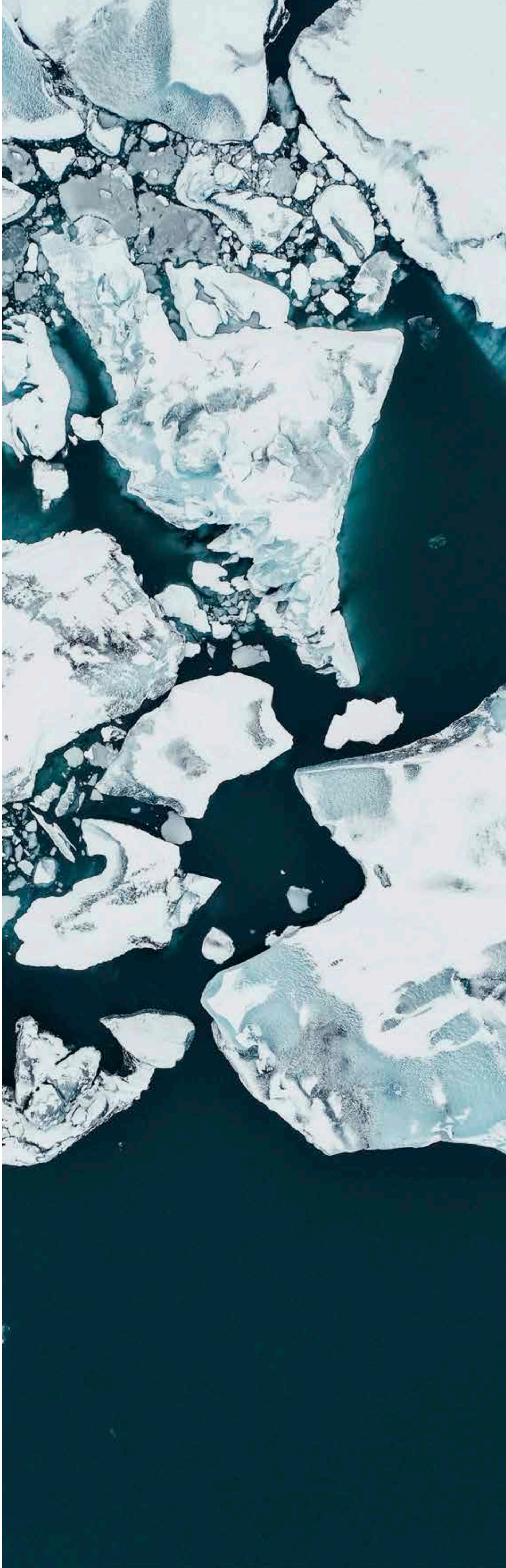
Increasing presence of quantitative ESG measures

Trends show increasing migration from qualitative ESG measures to incorporating more quantitative goals in executive incentives. Whilst most companies globally use a mixed measures approach (65 per cent) and it seems likely that this will continue, trends suggest companies are taking a more rigorous approach to setting ESG performance targets and the ranges around targets as they invest in data tracking and auditing mechanisms. Across all markets, companies are still more likely to measure ESG targets quantitatively in STI plans rather than in LTI plans. Progress towards empirical ESG goals may come with a risk of false precision and administrative burden. However, it remains a necessary step to provide greater confidence for boards when setting STI and LTI targets.

Considerations for directors

Executive incentives are a powerful and tangible governance mechanism for driving accountability and the remuneration committee's role is essential to getting the right design and the right outcomes.

- Are the scope and delegations of the remuneration committee optimal?
- How can your executive/management incentive scheme (short-term and long-term) include ESG and climate measures?
- Are the agreed measures and targets the right ones to incentivise action and not promote perverse incentives or drive unintended consequences?
- Is the percentage of variable remuneration commensurate to the scale of action required?
- Are the metrics measurable, significant, congruent and material?
- What feedback have you had from proxies, institutional investors and other shareholder groups on their comfort with your ESG measures and what actions do you intend to take to address this feedback?
- Do you have valid data measurement and collection mechanisms in place?
- Have you tracked the progress against your chosen ESG measures over time and considered whether the incentives are providing the appropriate return on investment?
- Are you disclosing how management remuneration drives climate action and links to shareholder value?
- Are the climate remuneration disclosures transparent and prospective?
- What monitoring is in place to ensure incentives doesn't lead to greenwashing?
- As climate reporting entities begin to report on their Scope 3 emissions, companies in their value chain can expect to be asked about emissions reductions and management. How is this going to be incorporated into the incentive structure?



About Chapter Zero New Zealand

The Institute of Directors in New Zealand (IoD) is proud to be the host of Chapter Zero New Zealand, the national chapter of the Climate Governance Initiative (CGI). This global network seeks to mobilise, educate and equip directors with the skills and knowledge necessary to address climate change at the board level.

Chapter Zero New Zealand is grateful for the support of our key partners who provide guidance and expertise to help us serve the director community.

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