Want better ESG performance? Don't rely on sales or share price as drivers for incentives

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BlueSky Education

Short-term CEO incentives - also called bonuses - focused on a company's sales negatively affect ESG performance, and hinder ESG efforts, according to new research from Vlerick Business School. Remarkably, almost half of Europe's biggest firms offer these short-term sales incentives to CEOs, therefore ineffectively contributing towards wider ESG goals.

This research was conducted by Professor Xavier Baeten, Director of the Executive Remuneration Research Centre at Vlerick Business School, alongside Marthe Van Hove, Research Associate at Vlerick.

The study examined pay levels and incentive systems of CEOs of the STOXX Europe 600 – a stock index of the 600 largest firms across European countries, including 150 UK firms. Firms such as Adidas, Santander, Unilever and Tesco are included in the STOXX 600.

The researchers examined self-collected information about pay levels, pay structures and KPIs included in incentive systems of leading CEOs, and used an external database (Refinitiv) to gather information on the firms' ESG performance. The researchers found that the CEO pay levels had zero impact on a company's ESG performance.

However, a CEO's pay structure did have an impact on ESG performance. Firms that granted a large part of the CEO's remuneration in the form of long-term incentives (e.g., performance shares), have a lower ESG performance. This applied to not less than 135 firms out of 600 in the sample.

The researchers also found a link between the KPIs used in incentive systems and subsequent ESG performance. As far as bonuses are concerned, accounting focused incentives and, surprisingly, environmental KPIs were found to have a negative relationship with ESG performance. Whilst in terms of the long-term incentives, making use of Total Shareholder Return as a KPI negatively affected ESG performance.

Professor Xavier Baeten says,

"It's clear to see that companies are taking ESG performance more seriously, and actively looking to build in incentives that ensure the CEO has a key focus on ESG. In fact, over the last five years we've seen a 20% increase in CEOs having short-term incentives focused on ESG (from 40% to 60% of the firms), and in the long-term incentives have doubled from 10% to 27% of CEOs. However, many firms may be looking to tackle ESG, but crafting their incentives wrong, hence why this research helps to showcase the most effective ways for firms to do so".

The researchers, however, did find a number of remuneration criteria that had a positive impact on ESG performance. Strategy-focused KPIs in bonus systems such as implementing a new digital strategy, positively impacted on ESG performance.

The researchers also found a number of interesting CEO characteristics that affected a firms ESG performance. Whilst younger CEOs were linked with better ESG initiatives, as were CEOs who had been an inside hire, working their way up through their company.

In terms of the board, the researchers found that the average board tenure had an impact on ESG performance, with younger board members implementing more effective ESG strategies. Whilst smaller firms and firms with smaller debts and total assets also had a greater ESG performance.

Interestingly, the researchers also found a number of other key findings on the STOXX 600 CEOs, including the impact of covid-19 on their remuneration. CEOs average remuneration dropped by 13% in 2020, down to 2.59million euros. Over this period, short-term incentives decreased for CEOs, whilst the average grant value of long-term incentives increased.

The researchers hope that these findings will showcase the landscape of ESG performance at the leading corporate organisations in Europe, and provide a best practice to these leading companies and their CEOs on how to build incentives into remuneration to help make a better world.

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