Remuneration Policy and ESG: Towards Integrated Corporate Governance

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Abstract

This paper will explore, in the context of corporate governance, the relationship between remuneration policies and the Environmental, Social, and Governance (ESG) factors, analysing how ESG integration into pay structures can influence long-term corporate performance and accountability.
To analyse how ESG can incentivize long-term corporate commitment, we will deep dive on academic literature and recent insights, aiming to demonstrate that is possible to align management incentives with long-term sustainability and stakeholder interests, representing a shift toward a more sustainable and stakeholder-oriented corporate governance.
Our discussion will also highlight challenges, opportunities, practical implications, and emerging trends in this critical area of corporate governance, proposing recommendations for fostering ESG-aligned incentive systems.

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1. Introduction: The evolving landscape of Corporate Governance and ESG

Corporate governance, generally defined as the system by which companies are directed and controlled, have been traditionally focused on aligning the interests of management with shareholders' interests. However, recently, a more comprehensive definition acknowledges its role in preventing or mitigating conflicts of interest among a wider variety of stakeholders, including: shareholders, debtholders, non-financial stakeholders (such as employees, customers, and suppliers), and other types of shareholders (as, for example, controlling shareholders *versus* minority shareholders). This new broader perspective is particularly more relevant in Continental Europe, Asia, and other global contexts, where more concentrated ownership structures are prevalent, leading to potential conflicts between large controlling shareholders and minority investors.[1,2]

In recent years, the projection of ESG factors has starting to influence the corporate governance landscape. ESG considerations, like incorporating environmental protection, social equity, and improving governance practices, have shifted from a peripherical zone to the forefront of investment and corporate strategy. This movement is clearly driven by a growing recognition of climate change risks, the increased activism by some institutional investors, and by the redefinition of the corporate purpose, which tends to extend beyond profit maximization and include a broader societal value creation. As a result, companies are under increasing pressure to integrate ESG considerations into their core business models, strategic priorities, and, crucially, their executive remuneration policies.[3]

This paper suggests that remuneration policy might be a vital mechanism for translating abstract ESG principles into tangible corporate actions. By linking executive compensation to the achievement of specific ESG objectives, companies can incentivize their management to pursue long-term sustainability, fostering a "cascade effect" where ESG commitments at the investor level will not only influence the core practices at the investment level, but also throughout its supply chain.[3,4]

[1] (GOERGEN, 2018).
[2] (OECD, 2011).
[3] (Câmara, 2022).
[4] (Serrano de Matos, 2022).

2. Theoretical frameworks: literature review

The classical agency theory, exposed by Friedman (1962), outlines remuneration as a mechanism to align agents (managers) with principals (shareholders), under a narrow conception of fiduciary duty. This has long justified the incentive's structures linked to financial indicators.[8]

Michael Porter and Mark Kramer's seminal article, *Strategy and Society* (2006), introduced the concept of Creating Shared Value (CSV), arguing that aligning social progress with competitive advantages can generate value for both business and society. Their framework underpins a growing recognition that ESG metrics should be part of executive performance evaluations. David Chandler, in *Strategic Corporate Social Responsibility*, also argues Friedman's approach proved to be no longer sufficient. In 2022, Chandler contends that firms must create shared value by embedding Corporate and Social Responsibility (CSR) into their core strategy, particularly through performance incentives.[9,10]

More recent work by Rebecca Henderson in *Reimagining Capitalism in a World on Fire* (2020) and Ronald Cohen in *Impact* (2021) explores how ESG integration is reshaping capital allocation and leadership performance. Henderson advocates that firms pursuing authentic ESG objectives must align incentives with impact outcomes, while Cohen focuses on the transformative power of impact-weighted accounting to redefine fiduciary responsibility.[6,11]

Institutionally, Larry Fink's annual BlackRock letters since 2018 have catalysed investor-driven ESG adoption. His 2022 letter emphasized that “climate risk is investment risk” and urged boards to articulate how remuneration aligns with sustainability objectives. These public signals contributed to institutional shifts in governance practices.[12]

As far as we understand, the discussion on linking executive remuneration with ESG principles is rooted in the broader corporate governance theories, particularly the principal-agent framework and its extensions. The classic principal-agent problem, articulated by Jensen and Meckling, highlights the inherent conflict of interest between managers (agents) and shareholders (principals), rising from the separation of ownership and control. Managers, seeking to maximize their own utility, may engage in "perquisites" (on-the-job consumption) or "empire building" (pursuing growth at the expense of shareholder value), leading to agency costs. Remuneration, particularly through performance-sensitive payments, can be seen as a mechanism to align these conflicting interests.[1]

[1] (GOERGEN, 2018).
[12] (Fink, L. 2022).
[6.] Henderson, R. (2020).
[8] (Friedman, M., 1962).
[9] (Porter, M.E. and Kramer, M.R., 2006).
[10] (Chandler, D., 2022).
[11] (Cohen, R., 2021).

However, in contexts where ownership is concentrated, such as occurs in many European and Asian economies, the primary agency problem shifts from manager-shareholder conflicts to conflicts between controlling shareholders and minority shareholders. Here, controlling shareholders may extract "private benefits of control" through mechanisms like "tunnelling" (transferring assets from a company to the controlling shareholder) or "transfer pricing" (overcharging for services between related entities), often at the expense of minority investors. In such scenarios, the effectiveness of remuneration as a sole alignment mechanism is more complex, as controlling shareholders directly influence executive payment decisions. Nevertheless, even in these structures, appropriate remuneration can still play a role in promoting the overall company performance and reducing managerial shirking.[1]

The integration of ESG factors into remuneration policies, introduces a new layer of complexity and opportunity. Traditionally, performance metrics were the financial ones (as, for example, earnings per share and return on capital). However, the evolving understanding of corporate purpose and long-term value creation suggests that non-financial and ESG-related metrics are equally, if not more, crucial for the sustainable success of a Company. This thought aligns with the "stakeholder theory" of corporate governance, which suggests that companies should consider the interests of all relevant stakeholders, and not just shareholders' interests, for its long-term viability. By incorporating ESG into executive payment policies, companies can incentivize managers to balance financial performance with environmental and social impact, thereby addressing a broader set of agency problems that extend beyond the pure financial metrics.[2,4]

[1] (GOERGEN, 2018).
[2] (OECD, 2011).
[4] (Serrano de Matos, 2022).

3. What can be the rationale for integrating ESG into Remuneration Policy?

The decision to link the executive remuneration to ESG performance indicators can be driven by several powerful reasons:

- **To promote long-term value creation:** A key objective of corporate governance is to ensure long-term success and sustainability of the company. Traditional short-term financial incentives can encourage excessive risk-taking and biased decision-making that may harm the company's long-term prospects. Integrating ESG metrics, particularly those focused on long-term sustainability (e.g., reduced carbon emissions, improved employee relations), helps to shift managerial focus towards sustainable value creation. [2,6]
- **To mitigate ESG-Related risks:** Environmental, social, and governance factors pose significant financial and reputational risks to companies. Climate change, for instance, presents physical, liability, transition, reputational and regulatory risks with long-term implications. Similarly, social issues (e.g., labour disputes, product safety failures) and governance flaws (e.g., corruption, ineffective controls) can lead to substantial losses and damage to a firm's market value. By designing remuneration policies linked to performance on these ESG metrics, companies' incentive managers and other stakeholders to proactively identify, assess, and mitigate these risks, thereby protecting and enhancing firm's value. [1,2,3,4]
- **Responding to stakeholder's pressure:** Institutional investors, regulators, and the public are increasingly demanding that companies demonstrate strong ESG performance. Large fund managers, for instance, are incorporating ESG criteria into their investment decisions and actively engaging with companies on these issues. Stewardship codes, such as the UK Stewardship Code, encourage institutional investors to integrate ESG concerns into their investment and engagement practices. Linking executive payment to ESG performance, signals a company's commitment to these evolving expectations, which can enhance its reputation, attract sustainable investment, and foster stronger relationships with key stakeholders.[4]
- **Attracting and retaining talent:** There is a growing awareness among the workforce, especially the younger generations, of ESG factors. Companies with strong ESG commitments are more likely to attract and retain top talent, as employees increasingly seek purpose-driven work environments. By integrating ESG into remuneration, companies reinforce their commitment to these values, making them more attractive employers.[1,3]
- **Driving innovation and competitive advantage:** Proactive engagement with ESG issues can foster innovation and create new business opportunities. For example,

[1] (GOERGEN, 2018).
[2] (OECD, 2011).
[3] (Câmara, 2022).
[4] (Serrano de Matos, 2022).
[6] (Henderson, 2020).

developing sustainable products or processes can lead to cost savings, new revenue streams, and a stronger competitive position. Tying executive compensation to these outcomes incentivizes managers to explore and capitalize on these opportunities, moving beyond mere compliance to genuine value creation.[3,4]

[3] (Câmara, 2022).
[4] (Serrano de Matos, 2022).

4. Designing ESG-linked remuneration policies

Designing effective ESG-linked remuneration policies involves companies to navigate on several complexities, including defining appropriate metrics, ensuring objectivity, and integrating them seamlessly into the existing compensation structures.

4.1. Defining ESG metrics and Key Performance Indicators (KPIs)

The critical first step for a company is to identify which ESG factors are related to the company's specific business model, industry, and long-term strategy. This will require a deep reflection and understanding of how ESG issues might impact the company's value creation process and its stakeholders and assessments to ensure that the chosen metrics are genuinely relevant and not merely "box-ticking" exercises. [3,4,7].

Common ESG metrics that can be included on each dimension:

- **Environmental (E):** Greenhouse gas (GHG) emissions (Scope 1, 2, and 3), energy consumption from renewable sources, waste reduction and recycling rates, water usage, and biodiversity impact.[1,4]
- **Social (S):** Diversity and inclusion (for example, the gender balance at board and executive levels), employee welfare and relations (e.g., health and safety, training, turnover rates, profit-sharing schemes), community engagement, human rights in the supply chain, and customer satisfaction.[2,4]
- **Governance (G):** Board structure and independence, executive remuneration fairness and alignment, shareholder rights, business ethics, anti-corruption and anti-bribery measures, and internal controls.[2,5]

Beyond quantitative metrics, qualitative information and "Key Purpose Indicators" (KPIs that link to a company's broader purpose and long-term value creation) are increasingly important. This approach moves beyond simply measuring outcomes to assess how well the company is living up to its stated purpose and contribute to a sustainable future.[3,4]

4.2. Remuneration structure

The primary vehicle to integrate ESG factors in the remuneration structure is the variable component of the executive remuneration. Typically, this can involve:

- **Long-term incentives (LTIs):** the ESG metrics are best suited for long-term incentives plans (e.g., multi-year performance periods), because many ESG outcomes (as carbon reduction targets or cultural shifts, for example) require a

[1] (GOERGEN, 2018).
[2] (OECD, 2011).
[3] (Câmara, 2022).
[4] (Serrano de Matos, 2022).
[5] (European Commission,2014).
[7] (Khan, M., Serafeim, G., & Yoon, A. 2016).

sustained effort and results just appear after extended periods. This helps to combat the short-termism often associated with annual bonuses. [2,4]

- **Performance-based awards:** Compensation should be explicitly linked to the achievement of predetermined, measurable, and challenging ESG targets. These targets should be "ambitious and designed to enhance shareholder value".[2]

- **Clawback and Malus clauses:** These two mechanisms allow the reduction or recovery of variable remuneration, if ESG-related failures or misconduct come to light after bonus payment (e.g., environmental accidents, governance scandals). They reinforce accountability and discourage excessive risk-taking.[1,4]

- **Shares and Stock Options:** While share-based payments can align interests, their design must be carefully considered to avoid unintended consequences (e.g., excessive risk aversion if vested shares represent a large portion of wealth). Vesting periods should be sufficiently long (e.g., at least three years), to ensure alignment with long-term ESG goals. Non-executive directors typically should not receive share options to maintain their independence.[2]

- **Cross-company variable compensation:** Some companies (as Roche, for example) have already ESG KPIs included in the variable compensation for all employees. This not only ensures commitment from the management to the ESG values but also promotes accountability across all organization.

4.3. Governance of the Remuneration process

To ensure the credibility and effectiveness of an ESG-linked remuneration, a robust governance process will be essential. For that purpose, there are best practices that can be shared:

- **Existence of a Remuneration Committee:** A dedicated committee for remuneration, composed predominantly or entirely with independent non-executive directors, should be responsible to design, review, and oversee the remuneration policy. This ensures objectivity and minimizes possible conflicts of interest. [1,2]

- **Expertise and training:** Members of the remuneration committee, and indeed the entire board, need to possess sufficient "ESG literacy" and technical knowledge to understand complex ESG risks, metrics, and their integration into business strategy. This may require specialized training or the appointment of directors with specific ESG credentials.[3]

- **Integration with risk management:** There should be a strong link between the remuneration committee and the risk management function (e.g., cross-membership

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[1] (GOERGEN, 2018).
[2] (OECD, 2011).
[3] (Câmara, 2022).
[4] (Serrano de Matos, 2022).

with risk/audit committees), to ensure that incentives do not inadvertently encourage excessive ESG risks.[2]

- **Shareholder engagement ("Say on Pay"):** Shareholders should have a formal mechanism to express their views on the remuneration policy, ideally through mandatory and binding or advisory "say on pay" votes. This ensures accountability and encourages dialogue between the board and investors. The quality and timelines of disclosure on remuneration arrangements are critical for informed shareholder engagement.[2]

4.4. Transparency and disclosure

To build trust and enable an effective oversight, a comprehensive and transparent disclosure of remuneration policies and outcomes is fundamental. This might include:

- **Detailed remuneration reports:** Annual reports should provide a clear and concise explanation of the remuneration policy, including its link to ESG objectives, the specific performance criteria used, the weight of variable *versus* fixed components, and the rationale behind remuneration decisions.[2]

- **Individual disclosure:** While contentious in some jurisdictions due to privacy concerns or fears of an "upward pay spiral", individual disclosure of executive and board member remuneration is increasingly seen as best practice to enhance transparency and accountability. [2]

- **Risk-related disclosure:** Companies should disclose how their compensation policies and practices relate to risk management, particularly in the context of ESG risks. This helps investors to understand whether the incentive system might lead to excessive or inappropriate risk-taking. [2]

- **Preventing "Greenwashing":** To combat misleading or exaggerated ESG claims, regulators are implementing stricter disclosure requirements and auditing mandates for non-financial information. The emphasis is on "fact-based or data-based ESG information" to ensure credibility. Frameworks, like the EU's Sustainable Finance Disclosure Regulation (SFDR) and Taxonomy Regulation, aim to provide a harmonized approach to ESG disclosure and prevent "greenwashing" across all three pillars of ESG, not just the environmental one.[3]

[2] (OECD, 2011).
[3] (Câmara, 2022).

5. Challenges and Future directions

Despite the growing momentum, integrating ESG into remuneration policies faces several challenges.

Firstly, the lack of universally agreed ESG metrics and the fragmentation of report standards can make it difficult to compare performance across companies and industries. While efforts are underway to standardize reporting (as happens in the IFRS Foundation's Sustainability Standards Board), a globally unified approach is still evolving.[3,4]

Secondly, ESG factors often involve qualitative judgments and complex interdependencies, making it challenging to set precise, measurable targets. Overly simplistic KPIs can lead to unintended consequences or "gaming" by executives. Subjectivity and complexity are still problems to solve.[3,4]

Thirly, to ensure that ESG incentives truly promote long-term sustainability without encouraging short-term "hit-the-target" behaviour remains a key concern. A balance between short and long-term sustainability is still missing.[3]

Furthermore, while "say on pay" mechanisms exist, their effectiveness can be limited by shareholder passivity, particularly in dispersed ownership structures, or by the dominance of controlling shareholders in concentrated ownership systems.[2]

Additionally, different regulatory approaches across jurisdictions can create opportunities for regulatory arbitrage, where companies may seek to circumvent stringent ESG remuneration requirements. Effective enforcement by supervisory authorities is crucial to ensure compliance and prevent defective disclosure. [2,3]

Finally, as highlighted by the Wall Street example, the close ties between regulators and the financial industry, coupled with the influence of powerful lobbying groups, can hinder effective regulation and reinforce existing power dynamics, making it difficult to "rein in" certain practices. This risk extends to gatekeepers like auditors and credit rating agencies, potentially compromising their independence and ability to police corporate malpractice related to ESG.[1]

Future efforts will need to focus to refine ESG metrics, fostering greater transparency and accountability, and strengthening the independence of remuneration-setting bodies and external monitors. The ultimate goal is to create remuneration policies that not only incentivize financial performance but also drive genuine progress towards a more sustainable and equitable future.

IFRS - International Financial Reporting Standards

[1] (GOERGEN, 2018).
[2] (OECD, 2011).
[3] (Câmara, 2022).
[4] (Serrano de Matos, 2022).

6. Conclusion

The integration of ESG factors into remuneration policies is a transformative trend in corporate governance, signalling a fundamental shift towards a more holistic and sustainable approach to value creation. By aligning incentives with environmental, social, and governance objectives, companies can proactively manage risks, enhance their reputation, attract responsible investment, and foster a long-term perspective. While challenges remain in terms of measurement, standardization, and on how to ensure genuine impact, the evolving landscape suggests that ESG-linked remuneration is increasingly becoming a non-negotiable element of effective corporate governance. As the cascade effect of ESG continues to expand, it is imperative for boards, investors, and regulators to collaborate in developing robust and transparent remuneration policies that drive both financial success and societal well-being.

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