WEIGHTING: CONSIDERATIONS TO DETERMINE HOW TO WEIGHT E&S METRICS IN INCENTIVE PROGRAMS

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Part 4 of our series outlined different considerations for determining whether ESG metrics are more appropriate in a short-term or long-term incentive plan. **This article focuses on the key considerations for incorporating metrics and determining the desired overall impact of ESG metrics on incentive plan outcomes.**

Key Considerations – Incorporating ESG Metrics

Below are examples of a few considerations to help determine the preferred way of incorporating ESG metrics in the short or long-term incentive plans:

1) Consider if the metrics should be **stand-alone discrete metrics or grouped together in a basket**
2) Consider if the metrics should be a **weighted component in a scorecard or a modifier**
3) Consider the **desired impact of the metrics on overall realized/realizable compensation** (i.e., the appropriate weighting within the total compensation)

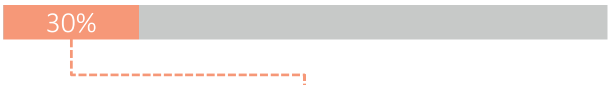
For illustrative purposes, we will be using "Employee Engagement" in a short-term incentive plan as the primary example. We note, the process is similar for a long-term incentive plan, however the dollar value/impact may be meaningfully more, depending on a company's pay mix/philosophy.

1) Basket vs. Discrete Approach

This illustration below details key considerations for whether the metrics should be discrete or basketed with other metrics. **We note a basket approach can provide the company with additional flexibility on both the metric selection process and performance evaluation, providing more flexibility for companies integrating ESG metrics into their compensation plans for the first time.**

Basket

This approach groups employee engagement with several measures together into a single "bundle", weighted 30% of the total corporate scorecard, where the weighting of each individual measure is not disclosed.



- Employee Engagement, Customer Satisfaction, Energy Management (30%)

The use of several metrics "mutes" the impact of each

Requires a balance between limited metric disclosure and still satisfying disclosure requirements

Discrete

This approach allows for employee engagement to be a stand-alone metric with a distinct 10% weighting and performance assessment within the corporate scorecard.

- Employee Engagement (10%), Customer Satisfaction (10%), Energy Management (10%)

Limited ability to apply discretion

Requires more sophisticated internal target setting and robust disclosure

2) Weighted Component vs. Modifier Structure

After determining a basket or discrete approach, the next step is determining if the metric should be embedded in the scorecard, or applied as a modifier. **As a guiding principle, modifiers have a more significant impact on payout than a modestly weighted component (i.e. 5%-10%) in the scorecard.**

Weighted Component

This structure allows employee engagement to be included independently in the corporate scorecard with a separate weighting (i.e., 10%)

40% Metric #1 + 50% Metric #2 + 10% Employee Engagement

- Can be structured as one metric (as shown above) or a "basket" of metrics
- Highlights the importance of ESG metrics relative to other traditional measures

Modifier

This structure applies a +/-10% employee engagement modifier to the total incentive score (can also be applied to a portion of the incentive score)

{ 40% Metric #1 + 60% Metric #2 } ✖ +/-10% Employee Engagement

- Can be more impactful on overall payouts which may reinforce the importance of ESG within the company
- May lead to misaligned impacts on compensation relative to performance if targets are poorly set / calibrated

3) Impact of Metric on Total Plan

It is essential to ensure there is a **balance between each metric having sufficient impact on the incentive plan while also ensuring the plan outcomes are aligned to overall corporate performance.** Given this balance, companies should consider the impact of each metric and the impact of the total plan.

	Less Weight	More Weight
Impact of Each Metric	Consider whether weighting is significant enough to warrant focus from participants	Consider whether weighting overshadows focus on other components of the plan
Impact on Total Plan	Consider whether this metric has enough ties to total payouts	Consider whether the metric has too much impact on total payouts

Summary and Next Steps

Ultimately, the company needs to consider the overall impact of an ESG metric on total compensation outcomes as it will help determine the appropriate structure / weighting of the desired metric. For example, if there is a high degree of comfort and confidence in target setting and measuring a metric, it may be logical to structure it as a stand-alone discrete metric with a higher weighting or as a significant modifier. The appropriate design may also be company size and industry dependent.

It is important to note incorporating ESG metrics will result in an inherent trade-off between the impact of traditional metrics (often financial and operational) and these new ESG metrics. Companies will need to ensure they are comfortable with these trade offs, and the potential impact to affordability, prior to implementation.

In the next article, we will look at how to determine the appropriate calibration for ESG metrics in the incentive programs.

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