ESG Overperformance? Assessing the Use of ESG Targets in Executive Compensation Plans

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Summary

Results

- 63% of S&P500 firms in 2023 include ESG metrics in their executive annual incentive plans (AIA)
- ESG targets are usually achieved, compared to financial targets
- Although ESG targets are usually meet, no real improvement in ESG performance (ESG score)
- Meeting ESG targets associated with weak governance, opposition in SOP votes

Strength

- Hand-collected data on ESG-linked compensation from proxy fillings for 2023
- Handles messy data to drawn interesting and novel insights on ESG metrics use
- Use GPT to audit the hand-collected data
- Policy implications for the need of more disclosure on ESG targets

Suggestions

Motivation

Research Design

Contribution

#1 - Motivation

- The paper tests two theories:
  - Theory 1: ESG targets signal a commitment by boards and executives to ESG values implying that executives work hard to achieve the goals.
  - Theory 2: ESG-based pay reflects poor governance by allowing CEOs to get paid for meeting easy (and less transparent) targets.

- Potential alternative hypotheses:
  - Executives may exert equal effort on ESG and non-ESG targets, and the targets may be equally difficult to achieve. However, ESG targets are more frequently met because executives typically have *greater control* over ESG outputs compared to non-ESG outcomes.
  - Are the reputational and turnover-related costs for executives higher when they miss certain ESG targets (e.g., an oil spill) compared to traditional performance targets (e.g., TSR)?

#2 Research Design

$$Y_i = \alpha_i + \beta_1 ESGScore_i + \beta_2 \overbrace{CEO_i + \beta_3 Eindex_i + \beta_4 Against_i}^{\text{Proxies for weak governance}} \qquad (1)$$

$$+ \beta_1 Size_i + \delta_i + \varphi_i + \varepsilon_i$$

- Y_i is either:
  - an indicator for whether firm i has adopted one or more ESG performance metric in AIA
  - an indicator for whether firm I has met or exceeded all the targets
- *ESGScore* (S&P Global) is measured at *t*-1 to capture whether firms that are ex-ante more committed to ESG are more likely to use ESG (testing part of Theory 1)
- Comments:
  - Consider running two different models for the two different dependent variables.
  - Control for peer adoption/use of ESG performance metrics, ESG shareholder proposals, violations occurrences, firm performance and volatility?
  - Are the results different when ESG performance metric are qualitative vs quantitative? Are weak corporate firms more likely to meet or beat ESG qualitative targets, but less likely to meet or beat quantitative targets?
  - ESG score at *t*-1 can be a result of incentives at *t*-1 => look at first time adoption of ESG metrics?
  - Are results robust to measuring ESG score using LSEG and Sustainalytics?

#2 Research Design

- CEO - Fraction of the company's voting power held by the firm's CEO: this varies negatively with firm size => maybe it explains the negative coefficient?

- Use other proxies for governance/CEO power - Coopt, CEO Tenure, CEO duality, % Institutional investors.

- *Against* is negatively associated with having *ESG AIA Target*, but positively associated with *All ESG Targets Met/Exceeded* – What is the take-away? Shareholders approve ESG targets, but not meeting those targets?

- Could it be that "negative" SOP is a reaction to another pay component, not ESG related?

Table 3

	(1)	(2)	(3)
	ESG AIA Target	All ESG Targets Met/Exceeded	All Financial Targets Met/Exceeded
ESG Score	0.00662***	0.0000173	-0.00336**
	[0.00143]	[0.00159]	[0.00154]
CEO	-0.932***	-0.329	-0.72
	[0.355]	[0.539]	[0.537]
Eindex	-0.0314	-0.0336	-0.0222
	[0.0377]	[0.0595]	[0.0431]
Against	-0.340*	0.441**	-0.22
	[0.177]	[0.219]	[0.186]
Size	0.0459**	0.00961	0.0661***
	[0.0218]	[0.0310]	[0.0242]
Constant	-0.208	0.513	-0.803
	[0.456]	[0.665]	[0.519]
Observations	495	244	474
R-squared	0.229	0.278	0.164
Industry FE	YES	YES	YES
Consultant FE	YES	YES	YES

Robust standard errors in brackets

*** p<0.01, ** p<0.05, * p<0.1

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#2 Research Design

Table 4

	S&P Global			LSEG			Sustainalytics		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
	2023 Score	2023 Score	2023 Score	2023 Score	2023 Score	2023 Score	2023 Score	2023 Score	2023 Score
2021Score	0.721***	0.699***	0.731***	0.706***	0.716***	0.715**	0.806***	0.794***	0.806***
	[0.0182]	[0.0247]	[0.0177]	[0.0261]	[0.0370]	[0.0253]	[0.021]	[0.030]	[0.021]
AIA_i^{ESG}	1.844***			2.092***			-0.28		
	[0.563]			[0.651]			[0.285]		
AIA_i^{Met}		-0.753	0.87		0.207	1.744**		-0.699	-0.187
		[0.932]	[0.532]		[0.864]	[0.598]		[0.492]	[0.277]
N	498	246	498	484	237	484	486	241	486
R-squared	0.828	0.805	0.825	0.752	0.699	0.752	.843	.870	.843
Industry FE	YES	YES	YES	YES	YES	YES	YES	YES	YES

Robust standard errors in brackets
*** p<0.01, ** p<0.05, * p<0.1

Comments:

1.Why 2021 score and not 2022? Consider defining the dependent variable as the Chg in Score and adding firm FE;

2. Consider interacting AIA^{ESG} and AIA^{Met} with governance characteristics and distinguish between qualitative and quantitative ESG metrics;

3. Does meeting ESG targets have other benefits for the firm? Reputation, increase in sales, lower likelihood of violations?

4. Look at MSCI scores - the largest and most influential ESG data provider (Christensen, Serafeim, and Sikochi, 2022)

#3 – Contribution

- Paper uses details of ESG performance metrics to provide insights into an understudied area: ESG-related compensation

- Contrasts with findings in Cohen, Kadach, Ormazabal and Reichelstein (2023) who find that adoption of ESG performance metrics leads to an improvement in ESG outcomes (i.e., carbon emissions).

- Franco, Imperatore and Ivanova (WP, 2025) show that firms with higher instances of non-financial violations within an industry incorporate ESG metrics in their executive annual bonus plans and that this association is more pronounced for firms facing stronger product market competition and external governance pressures, such as peer practices, shareholder activism, and media scrutiny.

#4 - Other Comments

- Are the results different for firms where the impact of meeting ESG targets are higher?
- Paper implies that fraction of total CEO compensation tied to ESG performance metrics is too low – Is it? Would it be optimal to be larger?
- Table 2: distinguish between firms with qualitative and quantitative targets (maybe impact of ESG target performance on CEO pay is larger for firms that use qualitative targets).
- How is “CEO Comp Impacted” calculated?
- Why was the year of 2023 selected? Was there a regulatory change, a notable shift in ESG reporting practices, or data availability constraints?
- Sample selection bias: out of 304 firms, authors could only determine whether ESG targets were missed, met, or exceeded for 247 firms. This may not be a random sample: firms that disclose performance may differ systematically from those that don’t.

Conclusion

- Greatly enjoyed reading the paper!
- Suggestions focus on increasing paper impact and contribution
- Best of luck!

Thank you!