

Beyond ESG: Executive Pay Metrics and Shareholder Support

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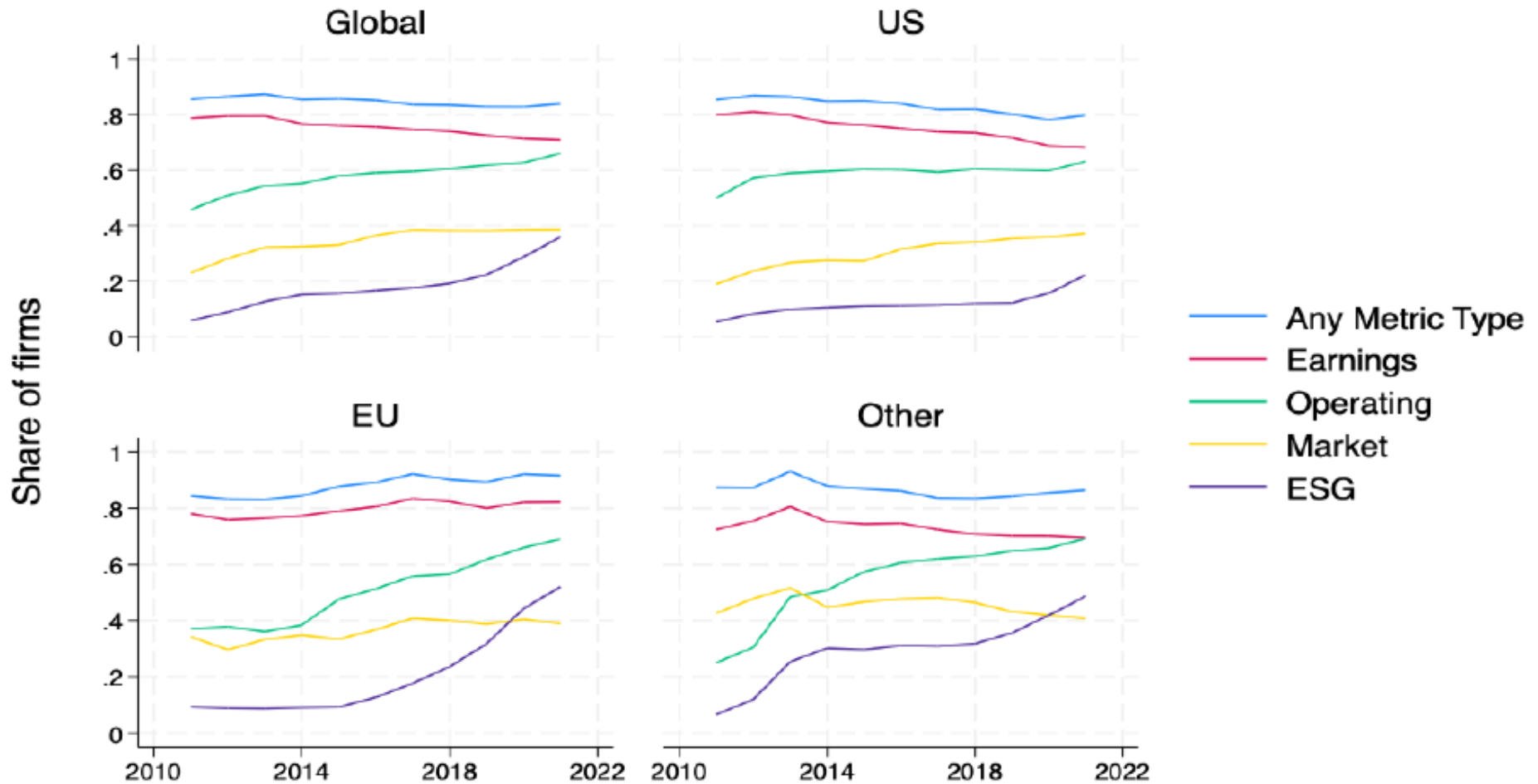


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Performance metrics in CEO pay

- Classifies the CEO pay performance metrics in 10,636 listed companies from across the world
 - 1) The use of ESG and other metrics
 - Increasing prevalence, high correlations across metrics
 - 2) The effect of ESG metrics on pay and pay-for-performance
 - Limited impact on payouts and pay-for-(ESG)performance
 - 3) Why are ESG metrics used?
 - “To build shareholder consensus on strategy and pay”

The use of performance metrics



More details, please!

- Which metrics are used in short-term (annual) vs. long-term incentive plans?
 - LTI plans >>> STI plans (at least in US)
 - Prior studies: ESG metrics almost exclusively in STI plans
- Which metrics are used in performance-vesting equity?
 - Prior studies: TSR & EPS
- Lots more analysis of which firms use which metrics, and how usage changes as firms change
 - Distinguish more carefully between within-firm changes and cross-sectional differences

Level of pay & pay-for-performance

- Firms that use more metrics pay their CEOs more
 - Driven by Operating and Market metrics, not ESG
 - May be reverse causality – high pay needs to be justified?
- ESG and other metrics have almost no effect on the **sensitivity** of pay to ESG and financial performance
 - Prior studies: ESG metrics carry immaterial weights; often discretionary; targets easy to achieve
 - Common interpretation: Greenwashing
 - Caveat: Because of performance vesting, market metrics likely to have a substantial effect on **realized** pay

Why are ESG (and other) metrics used?

- This study: “Compensation metrics are used to communicate the corporate strategy to shareholders and build shareholder consensus”
 - Argument:
 - 1) Using metrics does not link pay more closely to ESG or financial performance
 - Thus, need to look for a “non-incentive” explanation
 - 2) Using metrics **causes** higher SOP approval, fewer shareholder proposals, and fewer votes against management proposals

The effect of “underpowered” metrics

- Standard economics: Performance metrics will only alter behavior if they are tied to substantial payouts
 - CEOs as “coin-operated automatons”
- Arguably not a complete model of human behavior
 - “All faculty are expected to publish one paper per year, have teaching ratings of at least 4.0, and advise at least two PhD students. Everyone’s data will be made public.”
- If a board publicly sets performance targets based on observable metrics (sales, profits, ESG), the CEO likely does not want to fail
 - More research needed

Evidence for the causal effect of pay metrics on shareholder approval

- Using more metrics is correlated with shareholder approval
 - Might not be causal – could be an omitted firm type
 - If all firms choose metrics optimally to maximize approval, no reason to expect a positive correlation between the two
- IV strategy: Use ISS Peers' metric use as an instrument
 - Result: Firms whose ISS peers' use more metrics have higher shareholder holder approval
 - **No evidence for the paper's story:** If a firm uses more metrics only because its peers do, it does **not** communicate the firm's strategy
 - What's the explanation?
 - Probably an omitted firm type – ISS groups similar firms

External pressure matters

Q13a: Have any of the following ever caused you to offer an inferior structure of CEO pay to what you would like? (Y/N) (n=170)

	Yes	No
➔ Risk of “vote against” recommendation from a proxy advisor	54%	46%
➔ Risk of investor opposition	54%	46%
Restrictions from our approved pay policy	40%	60%
Restrictions from regulation or governance codes	36%	64%
Risk of controversy with employees, the media, customers, or policymakers	29%	71%
Unwillingness to deviate substantially from how we have paid in the past	16%	84%
Adverse tax, accounting, or disclosure implications	10%	90%

Q13b: Was the structure inferior in the following ways? (Y/N) (n=123)

	Yes	No
➔ We followed market practice more	69%	31%
We offered less upside for good performance	65%	35%
➔ We used (more) performance conditions	57%	43%
We made incentives more long-term	40%	60%
We made incentives more short-term	13%	87%

- Very interesting paper – lots of food for thought
- We do not have a good understanding of why firms choose ESG and other performance metrics
 - Incentives
 - To credibly convey the firm's strategy
 - Stakeholder pressure
 - Greenwashing
- Suggestion: approach the question with an open mind
 - Explore cross-sectional differences in external pressure, ownership, governance, firm life-cycle, etc.