pi ESG CLUB

What does institutional investors working to eliminate inequality in their portfolios mean for companies looking to attract and retain leadership talent? This month, the ESG Club looks at the difficult issue of executive pay.

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INSTITUTIONAL INVESTORS CALL FOR HUMAN CAPITAL REPORTING TO BECOME A GLOBAL STANDARD

Human rights have become a key issue among investors, finds *Andrew Holt*.

An investor coalition that manages more than $1trn (£795bn) of assets is calling on the International Sustainability Standards Board (ISSB) to make human capital and human rights a priority for its next set of global reporting standards.

A letter, co-ordinated by responsible investment campaigner Share Action and signed by 21 investors across the globe, states that investor demand for a greater volume of better-quality workforce data "is at an all-time high" and urges the ISSB to "prioritise researching human capital and human rights disclosure standards in its upcoming two-year work plan".

The investors, which include a mix of asset managers and asset owners, say they have gone to the ISSB specifically in response to its Request for Information (RFI) – launched in May 2023 – seeking feedback on which area of sustainability to focus its next set of standards on.

James Coldwell, head of the Workforce Disclosure Initiative (WDI) at Share Action, said this is "an opportunity" for the ISSB to "set the global reporting baseline" needed for investors to be able to understand and take meaningful action on labour and human rights abuses.

Joined-up thinking

The letter also calls on the ISSB to consider "how to disclose human capital and human rights information together" by addressing the connections between the two topics.

It argues that in practice, neither companies nor investors treat the two topics as separate areas.

Human rights due diligence processes, for example, are used as key tools for identifying labour issues. Concepts such as unionisation and modern slavery belong to both categories, argues the letter.

"We know that workers around the world face exploitation by unscrupulous companies, harming the workers themselves and creating risks for investors," Coldwell said. "Tackling these issues can only be achieved when there is transparency around corporate practices – something the ISSB is perfectly positioned to deliver.

"This is why we're calling on them to prioritise research into human capital and human rights, to develop a globally accepted reporting framework," he added.

The letter follows a Share Action poll that gauged how British savers feel about where their money is invested. The results show the majority (74%) have a negative view of financial institutions that invest in companies which fail to meet human and labour rights standards.

Asset owner requests

It is an issue that has momentum. As it comes after the UN-backed Principles for Responsible Investment (PRI) also called on asset owners to include human rights in their request for proposals (RFPs).

To do this, the PRI has issued a guidaince for asset owners: *How to identify human rights risks: a practical guide to due diligence,* which highlights that "investors should, where necessary, prioritise companies with the most severe actual and potential adverse human rights outcomes".

The PRI said asset owners who outsource some, or all of their investment management, should set clear expectations to their asset managers in terms of how human rights risks are identified and prioritised, and ensure that they monitor risk exposure and actions to address issues via regular information from their fund managers.

The PRI suggested a prioritisation framework to identify and prioritise human rights risks: through sector, company and country assessments – which should be tailored to suit individual investment strategies.

The Council on Ethics of Sweden's AP Funds have also set up an initiative, backed by Railpen, to put tech giants on notice over human rights risks.

Financial materiality

The aim of the initiative is to make sure tech firms take solid measures to address human rights risks in connection to their products and business models, while encouraging greater transparency and reporting on the related impacts.

The group cited engagement with Alibaba, Alphabet, Amazon, Apple, Meta, Microsoft and Tencent during the next three years to assess progress.

Vincent Kaufmann, chief executive of signatory Ethos Foundation, a charity to promote well being in society, said Covid-19 – and the subsequent mass fluctuation it caused in the labour market – emphasised "how critical human beings are to the long-term success of any business".

And he added: "As the financial materiality of these issues becomes increasingly clear, it is crucial investors have access to comprehensive and comparable social data from businesses to help inform investment decisions. It is imperative the ISSB prioritises developing human capital and human rights standards as soon as possible to help deliver this."

The WDI has also announced that it is launching an investor working group focused on global social data reporting, which will be launched following the closure of the RFI in early September.

INTERVIEW – MAHESH ROY

"Big change, particularly at big organisations, takes time."

The head of the investor practices team at the Institutional Investors Group on Climate Change (IIGCC) talks to *Andrew Holt* about addressing the challenge of climate change, fixed income, framework fatigue, the rise of greenhushing and his concerns for the future.

How are you trying to make a difference in the fight against climate change?

IIGCC is one of the world's largest global investor bodies focused on climate change. It operates through three teams.

There is the policy team, which was formed 20 years ago to work with institutional investors on climate change. Then there is the corporate team, which has been helping investors engage with corporates since 2015, including via Climate Action 100+.

Finally, I lead the investor practices team to help institutional investors incorporate climate change into their investment strategies. This team was introduced in 2019 after what is now known as the Paris Aligned Asset Owners was formed. The initiative led to the development of the Net Zero Investment Framework, which marked a step change in how investors address net zero.

I started working in this space in 2020. During this period, we have seen rapid growth in companies and investors pledging their support to net zero as well as a greater scaling up on the issue.

The investors practice was only created in 2019. That seems a little late.

In terms of where investors were, it was the time when the [climate change] issue started to evolve. IIGCC had already been addressing it on a policy and engagement level for many years.

From the perspective of incorporating climate change into investment strategy at scale, it is relatively new. All the investor frameworks and alliances started around this time. The Net Zero Asset Owner Alliance, for example, was created in 2020 along with the Net Zero Asset Managers and Paris Aligned Asset Owners initiatives.

We can see, therefore, that a lot of progress has been made in three years. While some say we need to go further and harder, you have to remember the size of change we're talking about. In short: big change, particularly at big organisations, takes time.

What is the most challenging part of your role?

Prioritising what is important for our more than 400 members. They are mainly pension funds and asset managers spread across 27 countries, with around £56trn in assets under management.

We have so much to do and will focus on the work that will have the most impact. But it is a privilege to be entrusted to do this work.

How, in your view, are institutional investors approaching the climate change challenge? What are they good at and what needs work?

They approach the challenge, as you would expect investors to do, with rigorous analysis. They try to use the best available data.

Institutional investors have come a long way in a short period of time in net-zero investing. They most definitely take the challenge seriously.

On where there is more work needed: they haven't been so great at integrating physical climate risk into their investment decisions. But they understand there is work to do here and the need for marrying long and short-term risk.

Is there a difference in approach between how asset owners and asset managers are dealing with climate change?

Asset owners have a long-term view and have to make the necessary changes in

asset allocation while thinking more on a macro level.

For asset managers, they are for-profit businesses. They all have their specialities, and what they do is tied to the mandates awarded by their clients. There are boundaries to what they can do within those mandates.

What is important, and useful, is that the Net Zero Investment Framework is a common framework used by asset owners and asset managers on the issue.

Do asset owners or asset managers need to do more work on this issue?

There is evidence of lots of good work underway already. However, while asset owners may face challenges around resources, the larger asset managers arguably face the more complex challenges owing to the number and variety of mandates they have.

It's important to recognise that there are lots of different types of asset manager with different approaches, so it is hard to generalise.

However, what we can say is that any perceived slow progress in implementing net-zero plans is not for want of trying. We're seeing huge efforts here, including the building of entire teams.

Are the targets set by government and industry bodies stringent enough to address climate change?

At this stage, no. The Net Zero Investment Framework highlights the need for investors to be proactive in this space. But things have moved quickly and governments have generally been reluctant to regulate businesses because they don't want to curtail economic growth.

Some of the friction we are seeing is down to the fact that investors can only do so much on climate change. There is a need for certain bodies, including policymakers and regulators, to catch up to where investors are.

What needs to happen from a political and regulatory viewpoint?

Some things are happening. An example is President Biden's Inflation Reduction Act – which is designed to incentivise growth in the green parts of the economy. That helps to show where money should be going by sending the right price signals.

As far as regulation goes, first and foremost the net-zero initiatives and frameworks were always intended to be voluntary and be a guide for how investors could undertake things. They never have, and never will, aim to be quasi-regulatory. That is not their role, mandate or purpose.

One area where it would be helpful to have clearer guidance is on competition law and fiduciary duty. We've seen some positive and helpful signals in the UK and in Europe, which have made things easier.

There has been a spate of institutions withdrawing from climate change initiatives, such as the Net Zero Insurance Alliance. Why is this happening and does it worry you?

I can't speak for the insurers but there are reasons for joining different initiatives and there are different political risks in different geographies. It is worth noting though that a lot of those insurers with asset owner businesses are staying in those asset owner alliances.

This also highlights the different approach from insurers, who address risk, and investors who can see the investment opportunity presented by the transition to net zero.

The push back against climate change looks politically motivated, especially with an election coming up in the US. Is this worrying?

We are looking at changing some big engines of the global economy, so it is naïve to think that there would not be any resistance.

On a political level there are positive examples. If you look at the Australian case, it was shifted through an election by voters wanting to make a positive adjustment on climate change. In the UK and EU, if it is done in a fair and just way, there is support for the transition.

But there is friction in some areas. And there will always be that friction given how much we want to change. However, I am not worried that we are going down the wrong track – overall, the momentum is clearly behind the transition.

The Church of England Pensions Board has left the Net-Zero Asset Owner Alliance. This was due to it also being part of the Paris Aligned Asset Owners initiative and it not being tangible to maintain two reporting frameworks. What lessons do you take from this?

The alliance and the framework are two separate entities focused on achieving the same end. Therefore, the Church of England Pensions Board decided to rationalise and go with only one of them. That makes sense from the administrative side.

In some parts of the wider press, it was presented as a bad thing and a worry, but that wasn't the case. In fact, it shows they are taking this seriously and working out the practical implementation of their plans.

Isn't the lesson though that investors could be getting bogged down by an excessive amount of net zero and climate change initiatives?

Ultimately, as long as there are the baseline standards, it does not matter what route to net zero investors choose, they are going to get there one way or another. Connected to this, we are looking at the best ways for investors to pledge their net-zero targets. As a lot of investor sustainable reports are patchy, we need to work towards more streamlined standards building on some of the good work to date, including the ISSB standards.

Do you support investors who wish to divest from companies which are failing on climate change, or prefer them to use their clout to drive change?

I wouldn't favour investors going one way or the other, without knowing their specific situation. But there are a few studies showing that mass divestment as a movement does not change the cost of capital for companies and that investment is still available even if others take a stand and divest.

Critically, we have seen that investor engagement works, as seen by the results achieved by Climate Action 100+. Ultimately, it can shift the way companies approach net zero and can move the dial over time.

In Australia, for example, we've seen the role institutional investors have played in getting Qantas to speed up their net-zero targets.

IIGCC created the Net Zero Standard for Oil and Gas companies. How will that help investors?

It offers a benchmark for investors engaging with oil and gas companies and the steps they need to take to align with net zero.

Setting out different aligning criteria and best practices, including transition plans, gives companies a benchmark. So when investors engage with oil and gas companies they know that they need to do x, y and z as there is a benchmark to refer to and measure them by.

IIGCC has issued net-zero guidance in an attempt to encourage bond engagement. What is the ultimate objective there?

A lot of the activity investors have had around climate change has been with equities. There is now a focus to put that on fixed income.

There are different levers and different ways of looking at fixed income, which is a large asset class. Ultimately, there is a question of how investors use their position as holders of equity and debt and the levers this gives them to support businesses make the transition to net zero.

How much of a problem is greenwashing?

The issues around greenwashing that emerged a few years ago have subsided to some extent. On a day-to-day basis, I do not come across it much, if at all. It is mostly used in advertising [of investments] to play up certain credentials, which are, in fact, not there.

There has been some good, clear guidance, particularly in the UK among regulators about what they will stand for and what they won't as far as climate claims go. Overall, we see little of it these days.

The term 'greenhushing' is more applicable. For instance, where [EU] Article 9 funds are moved to Article 8 because investors don't want to be seen pushing too hard on this. They want to be more understated than overstated.

What would you say IIGCC is good at and what needs improving?

We have been good at assisting and bringing asset owners and asset managers together to rapidly move towards net zero, as seen by the success of the net-zero initiatives. It has been more successful than we imagined two or three years ago and has been done in a partial policy and regulatory vacuum on how to address the goals of the Paris Agreement.

In terms of areas for development, we need to continue to make the case for net-zero commitments and to explain our role within this. For instance, we need to continue to explain that net-zero initiatives are there to provide a platform for ambition and disclosures, and to give an idea of what is possible into the future – not to act as a quasi-regulatory body or to police greenwashing. The aspirational narrative sometimes gets lost.

What are your hopes and fears in terms of institutional investors addressing climate change?

I hope investors continue at the pace and passion over the next decade that they have shown in addressing the issue in the last four years.

While the pace of change was always going to come up against some friction, including from organisational change management, we can't afford to see the pace slow too much during this difficult phase. Ultimately, I just hope organisations stay the course and keep up the good work as climate change is not going away.

EXECUTIVE PAY: JUST REWARDS?

With concerns over social inequality growing, how much is too much when it comes to rewarding the people sitting in the boardroom? *Mark Dunne* reports.

Big is not necessarily beautiful. The rewards executives receive for leading a company are facing greater scrutiny as anger over inequality has led to strikes, protests and defunding campaigns. It's bad for business if directors receive six-figure salaries, bonuses, shares and pension contributions while the guys working on the shop floor are struggling on the minimum wage.

The chief executive of clothing and homewares retailer Next being handed a 50% pay rise at a time when families are struggling is the latest example that has put the issue under a microscope. Tesco and the Restaurant Group, which owns Wagamama, have also faced questions from shareholders concerning the rewards they have handed their leaders in difficult economic times.

Finding a balance between companies needing to attract and retain talent while avoiding accusations of being greedy is not easy. "Talent at the top can make a difference in terms of financial performance, but they need to balance having strong leaders with a prudent allocation of investor capital and robust, objective and transparent incentive metrics," says Peter Dervan, senior director of stewardship at Manulife Investment Management.

Karoline Herms, senior global ESG manager at Legal & General Investment Management (LGIM), has two decades of investment management experience, which has seen her work with companies on their remuneration proposals. "Remuneration has been a bit of a hobbyhorse for me," she says. "It is a window into a company's governance structures, which, as an external investor, you don't often see.

"You get to see who is really wearing the trousers," she adds.

When is enough…enough?

Herms says that LGIM trusts boards to govern their company, which includes setting management remuneration. "Essentially, we trust them to do it right, but we take our responsibilities as an active shareholder seriously. We know our voting rights when looking at remuneration proposals and the accountability of directors," she adds.

The decision on what is appropriate to incentivise management lies with the remuneration committee. "If it is their belief that they must give a significant pay award, they can do so as long as it's structurally long-term aligned, reflects strong performance and is potentially measured against benchmarks," Herms says. "We want to see the management outperform the market.

"We also expect the committee to look at other issues. So, for example, the stakeholder experience, the size of the company, market sentiment, and, especially if it is a large payout, potential reputational risks. These cannot be ignored. "Ultimately, it is the committee's responsibility to persuade us that a pay award is justified," Herms says.

LGIM doesn't have a threshold for how much a company pays its senior leaders. A pay deal being linked to long-term sustainable performance is more important. "We look at the structure of pay and how it aligns with the experience of the workforce, of the shareholders and wider society," Herms says.

Although useful, the ratio of how much the chief executive is paid compared to that of an average employee can be confusing. "We accept that comparability is difficult across different companies and sectors. It is not a red flag for us," Herms says.

When assessing if an executive's pay is extravagant, comparing the pay structure to a reasonable peer group could help. "If a company pays its executives to a degree we deem excessive relative to their peers, we may have an issue with that," Dervan says. "You need to incentivise executives to remain with the company, but success is defined potentially differently by different parties," Dervan says.

Cash or paper?

The structure of the pay package also needs to be considered. A large bonus may seem extravagant, but it could only be paid if the company hits certain targets. An executive receiving a $1m cash bonus, for example, is likely to be a different proposition from receiving the equivalent in shares. "We might have better tolerance for payments made in equity as opposed to cash if those equity awards are tied to strong operational hurdles. Achieving that equity payout could significantly enhance shareholder value," Dervan says.

It is not just a question of why an executive is being paid so much, but how, or when, it is paid. "Is it purely in their salary, where they just need to sit in their seat to earn pay, or tied to strong financial or operational metrics that could result in unlocking shareholder value?" Dervan says.

"We are long-term investors; therefore, we want pay packages weighted towards three-to-five-year periods," Dervan says.

"We want to incentivise outperformance against a peer group and we want to incentivise alignment with shareholders through equity ownership, so we want [pay packages] weighted more towards equity compensation than cash," Dervan says.

"We want robust challenging metrics over the longer term," Dervan says.

The right metrics

You want metrics that incentivise fundamental outperformance. Return on invested capital is such a measurement, which is weighted towards not just equity, but performance-related equity.

The wrong incentives can certainly threaten long-term value.

Peter Dervan, Manulife Investment Management

"You need to incentivise executives, but you need to do it in a responsible and reasonable way through a responsible and reasonable use of shareholder investor capital," Dervan says.

"The wrong incentives can certainly threaten long-term value," Dervan says. "That is why we work with companies to encourage the right metrics and the right incentives that seek to drive outperformance over the long term.

"You could have a good year of performance, but is that worth a significant increase in pay? We want to incentivise performance against the long term," Dervan says.

"It may not be enough just to look at stock performance. It is great if the stock price goes up, but we pick companies for a reason. We pick them because we expect them to outperform the market," Dervan says.

He doesn't want executives benefiting from just riding the market. "Some people could point to a share price going up over the last year, but if everybody's share price went up you have performed thanks to macro tailwinds. Nothing fundamentally has changed at the company," Dervan says.

"A revenue target could encourage executives to empire build, to just go after acquisition after acquisition without measuring the success of any post-merger synergies," Dervan says. "The right metrics, like return on invested capital, can help balance that."

Different strokes

It is difficult to compare the responsibilities of the directors to those of the wider workforce. "Directors are having to walk a bit of a tightrope here," Herms says. "Different risk and responsibility levels are rewarded differently.

"Executives are employees of a company and work on behalf of shareholders and other stakeholders, from the workforce to the supply chain," Herms says. "For that they are generally quite well paid. They get a salary, a bonus and participate in share incentives."

Clare Richards, director, social, in the responsible investment team at the Church of England Pensions Board, says that no one is saying everyone should be on exactly the same pay. "That's not the point," she adds. "It is about getting a more holistic sense of what rewards mean within a company, rather than just being fixated on one or two numbers."

Shareholders should not fall into the trap of high pay, means high reward. "Interestingly, we have not found clear evidence of a link between high pay and better performance, which is essentially what shareholders want," Herms says.

She points to research by not-for-profits and Morgan Stanley that shows high pay does not necessarily produce high profits. "In fact, over the years, their total shareholder return is less than that of other companies'," Herms says.

Under pressure

A wide pay gap between directors and the factory-floor employees could cause unrest leading to low productivity and strikes, which could ultimately impact profitability. "The biggest risk for a company is a disconnect between management and the workforce," Richards says, adding that it is all down to communication. Does the workforce understand that the executive team are driving the value creation needed to protect the jobs of the wider workforce?

There are other risks. "Consumer-facing companies could face a public backlash," Dervan says. "Consumers seeing such a wide pay gap between workers and senior management could become a brand reputation issue."

Manulife has enjoyed some success in ensuring that corporates are not being extravagant when paying their executives.

We have not found clear evidence of a link between high pay and better performance, which is essentially what shareholders want.

Karoline Herms, Legal & General Investment Management

This is the result of a mixture of policy and support for shareholder proposals to get boards to think about the ratio of CEO to median worker pay.

"We have seen more disclosure of that ratio," Dervan says. "We need maybe a little more of a history of data to see how it correlates to company performance and the workforce, but at least that data point is out there for boards and investors to consider."

Sustainable gains

Income inequality is not the only issue here. "This is another externality investment managers need to grapple with in sustainable investment, like climate change or water risk," Dervan says.

Herms says ESG issues can be financially material in the medium to long term, so this should be linked to executive remuneration but warns that when it comes to the metrics, there is no one-size-fits-all solution.

"Not all ESG metrics are made the same," she says. "It is going to be specific, based on the sector, and on where the company is in terms of disclosures."

Herms says that LGIM asks companies, especially those carrying higher ESG risk, to include relevant and measurable targets in their executive pay packages. "Our mantra is what gets measured gets done," she adds. "If the metrics have a direct impact on an executive's take home pay, the attention they give that will be manifold."

Including appropriate ESG metrics in executive pay is much more than just signaling. It should address financially material risks and opportunities. "We would expect companies that have a big influence on the climate to include climate transition targets in their pay."

Like emission reductions, and water conservation, these issues cannot be solved in a year. Dervan is seeing more companies including environmental and social factors in terms of their annual bonuses. "Right now, companies are comfortable in the one-year term, measuring these and incentivising them, but they are struggling with incentivising them over the long term."

Quantitative metrics investors can measure year on year include: how many tons of greenhouse gas emissions were reduced? How many gallons of water did you reduce? By how much did you reduce your exposure to deforestation in your supply chain?

Companies are integrating environmental and social factors into their executive compensation plans, but for Dervan, more work is needed in this area. His concern is these factors are not being included in longer-term pay packages.

Unless investors treat the topic of executive pay seriously, they could lose out while executives laugh all the way to the bank.