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Paying Well by Paying for Good? – A Review of ESG-Linked Compensation Research

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Abstract: "ESG", as values in the global sustainable transformation, drives technology, societal and institutional innovation and its uncertainty influence corporate's strategic management and operation activities. Incorporating ESG metrics in executive compensation has become a trend of corporate governance for global companies in recent years. First, this paper theoretically reviews internal and external factors of the ESG-linked compensation incentives, analyses the specific governance mechanism. On this basis, this paper summarises ESG performance and corporate financial performance incurred by ESG pay. Lastly, this paper puts forward future extensive research direction and provides references for subsequent research. Specifically, governance effect by ESG-linked compensation needs to consider institutional feature (developing country and developed country). The consistency between "carbon emission" policy and economic development determines that ESG performance is limited by the economic development stage and industrial structure of the country. This review contributes to construct analysis framework by Governance Incentives $\rightarrow$ Governance Mechanism $\rightarrow$ Governance Effect to conclude general rule and future research prospect of ESG pay.

Keywords: ESG, CSR, Executive Compensation, Corporate Governance

1. Introduction

"ESG", an extensive concept of "CSR", was first introduced in a report jointly launched by 20 financial institutions at the invitation of the United Nations – Who Cares Win. COVID-19 and the global carbon race put ESG standards on the track. Global Sustainable Investment Review (GSIR) 2022 indicates that global sustainable investment assets reached $30.3 trillion [1]. Meanwhile, the global corporate sustainability process has also reached an inflexion point. As a powerful lever to promote a sustainability agenda, executive compensation was valued by more and more companies. 72% of S&P 500 companies incorporated ESG incentives in 2023 and compared to a 23% increase in 2022, there was a net increase of 2.8% by companies implementing ESG incentives. ESG + Incentives 2023 Report shows that carbon footprint and energy efficiency metrics experienced rapid growth and became the first two choices of environmental indicators of incentives. The key method contributing to achieving sustainable development goals and global greenhouse gas reduction targets may be to incentivize managers to adopt and implement Global Reporting Initiatives (GRI). Global corporates continued to shift toward formal, weighted structures for ESG inclusion rather than

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discretionary structures, while metrics were more often included in annual incentive plans (AIP) rather than long-term incentive plans (LTIP).

ESG research in corporate finance is an extensive and comprehensive topic this article is focused on the perspective of internal corporate governance and empirical research on ESG compensation is reviewed. On this basis, the contribution of this review may include (1) a systematic review of the development context and the latest progress research on the governance effect of ESG compensation contracts. According to the logical main line of Governance Incentives → Governance Mechanism → Governance Effect, the general rules of ESG pay governance are extracted, which provides experience and reference for subsequent research. (2) This paper makes an overall review of relevant studies on governance effects of ESG-linked compensation, excavates, and sorts out the relative shortcomings of existing studies and puts forward future research prospects. (3) This review also concludes the current shortcomings of incorporating ESG metrics into executive compensation contract practice and puts forward suggestions on how to build ESG compensation governance structure for enterprises.

2. Governance Incentives of ESG-Linked Executive Compensation

2.1. Agency Theory

Principle-agent theory states that senior executives are motivated to use their discretionary power to seek rent if the enterprise lacks an effective incentive and supervision mechanism, thus maximizing self-interest at the cost of shareholders [1, 2]. Effective Contracting Theory studies the role of financial accounting information in alleviating the information asymmetry between contract parties, which is conducive to the formation of effective contracts, the play of fiduciary responsibility and effective corporate governance. Fligstein and Freeland conclude that the Principle-Agent Theory determine the most effective contract governing the principle-agent relationship [3].

2.2. Optimal Contracting or Good Governance

From the perspective of effective contracting theory, ESG-based remuneration implemented in enterprises can be explained by stakeholder theory, shareholder theory and institutional theory. The shareholder theory from the perspective of corporate governance takes the maximization of shareholders' interest as the only goal, and the design of the executive compensation structure aims to reduce the agency problems caused by the separation of ownership and control, to make the interests of shareholders and managers consistent [2, 4]. For example, the Carbon Border Adjustment Mechanism published by the European Union (EU) will impose carbon tariffs (the difference between the carbon price paid by producing countries and the price of carbon allowances in the EU Emissions Trading System) on six categories of goods - cement, electricity, fertilizer, hydrogen, steel, and aluminum -from 2026. Lower ESG performance is more costly in the coming years. Shareholder theory could explain ESG-based remuneration incentives as lower negative externality costs. ESG-linked compensation is more likely to be initiated after the engagement by the three largest asset management companies.

Legitimacy theory assumes that an organization has an implicit social contract with the society in which it operates [5]. This society contract motivates managers to implement appropriate structures and processes to abide by societies' values, norms, and boundaries [6]. The organizations will implement a legitimacy strategy if there exists a legitimacy gap. The presence of some metrics focusing on specific items such as carbon emission reflects regulatory requirements or firm value drivers. Iliev and Roth find that the U.S. firms exposed to the changes in regulations and reporting requirements improve the financial situation [7].

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The stakeholder theory from the perspective of corporate governance proposes that enterprises should pursue long-term shareholder wealth and pursue sustainable growth based on being responsible to stakeholders [8]. As a non-financial indicator, ESG is included in the executive compensation can reduce the short-sightedness of managers and encourage them to shift their target to the long-term value growth of the enterprise, as an incentive means for the company to maintain its reputation and enhance long-term shareholder value [9]. Zumente and Bistrova find that firms with better ESG performance can enhance long-term shareholder value through various factors related to firm value [10]. They further report that better ESG performance brings out financial performance improvement and long-term financial advantage. For example, higher net profit, return on equity, increased cash flow liquidity, and better access to finance, lower cost of capital [11]. Better ESG performance correspondingly leads to lower market volatility, lower credit risk and business risk, higher market valuation and higher levels of institutional ownership [12]. Higher reputation and customer retention can be brought by well-performed ESG, therefore decreasing employee turnover costs and increasing sales.

Jensen argues that “enlightened shareholder wealth maximization” in essence aligns the interests of shareholders with the broader interests of society and the environment [8]. Enterprises can thrive and generate sustainable returns through creating values for stakeholders, not only shareholders.

2.3. Non-Optimal Contracting or Agency Problems

On the contrary to efficient contracting theory, Lucian and Jesse argue that the CEO and his management team have considerable influence on the board of directors in the listed companies where ownership and control are separated [13]. When managers have excessive power, entrenched positions or cooperate with board members, they can exercise greater influence on the way they are compensated [14]. ESG performance metrics are sometimes significantly subjective although these metrics can be measured objectively. Bechuk and Tallarita argue that the CEO has incentives to design and manipulate ESG metrics to make self-interest, decoupling genuine ESG efforts from performance measurement, increasing agency cost and harming shareholder wealth [15]. Alternatively, shareholders collude with executive managers to use ESG pay as a tool of impression management or window-dressing and to sign stakeholder commitment to society can cover up corporate misconduct (Greenwashing) or enhance corporate image, even if agency costs are increased in the short term.

2.4. Empirical Research

Former studies related to ESG compensation focus on whether ESG pay raise agency problems between shareholders and managers. Ferrell et al. find that CEO compensation is negatively related to ESG scores [16]. Gillian et al. find that the CEO has lower compensation in companies with better ESG performance, indicating that even if ESG metrics are designed by managers for rent-seeking, ESG compensation is a substitute for compensation but not a complement [17]. Similarly, Jian and Lee find a negative relation and the CEO is rewarded by normal ESG investment and punished by ESG activities that deviate from the expected return [18].

Recent studies focus on the motivations of ESG-linked executive compensation contracts. Cohen et al. support the argument that firms implement ESG pay to appeal to shareholders and align with stakeholders’ preferences; ESG pay adoption is accompanied by corporate pledges to ESG criteria, which signals a commitment to improve ESG outcomes; ESG metrics in executive compensation as well explained as incentive contracting to lower future risk of standard assets because of climate change or geopolitical unrest [19]. Homroy et al. also explain that institutional shareholders are exerting pressure for increased transparency and disclosure regarding ESG initiatives [20]. They further find the consistency of ESG-based remuneration with shareholder utility.

The incorporation of ESG into the compensation contract is one of the means to study the sustainable development process of enterprise at the micro level. Most existing studies analyze the inside-out or outside-in ESG compensation motivation. The specific driving factors are affected by the market characteristics, for example, country (macro policy, economic development stage, etc.), region (regulatory intensity), industry, corporate characteristic (size, state-owned or not), etc. However, no relevant empirical research has shown what kind of motivation dominates. Most current empirical research conclusions support the view of optimal contracts, that is, good governance, and no rent-seeking has been found.

3. Governance Mechanism

The governance mechanism of ESG-based remuneration is separated into external governance and internal overview to conduct an overview in the following context.

3.1. Internal Governance

From the perspective of internal governance mechanism, the main research focuses on the characteristics of the board of directors and ESG-based remuneration structure.

3.1.1. Board of Directors and CEO

The board takes charge of corporate socially responsible agenda, policy and report. Board compensation policies can benefit key stakeholders by encouraging boards to play a central role in monitoring and integrating EGS risks and opportunities to create long-term value opportunities. The board’s interpretation of sustainable development activities is an important criterion to reflect shareholder’s compensation decisions of the board. By meeting stakeholder requirements through good sustainability performance, these investors have a more positive view of the board, which is especially responsible for evaluating the activities of top management. In response, companies evaluate directors more positively in the form of rewards, incentives, and compensation due to the visibility of key stakeholders and their impact on monitoring board activities. As a result, boards are increasingly sensitive to providing incentives and bonus programs to managers in the form of compensation to achieve sustainable value creation [21]. In the context of corporate-related activities, the oversight role of the board appears to be critical to addressing the long-term nature of carbon-related investments and opportunities for corporate social responsibility engagement by underperforming executives [22].

Studies related to ESG internal governance focus on the characteristics of the board of directors and CEO. Liao et al. argue that high-level independence boards have a positive effect on the supervision of senior managers and further find that corporate ESG performance is positively related to the independence of boards of directors [23]. Jizi finds that boards equipped with better ability and diversified experience increase efficiency and enjoy better corporate socially responsible outcomes [24]. Birindelli et al. find that the degree of diligence impacts corporate social responsibility performance [25]. Tuggle et al. argue the duality factor if the CEO, in which the CEO serves as the chairman of the board, may negatively impact oversight [26]. Executive personal characteristics are also included in widespread research. Multinational board members, women leaders, CEOs with daughters, married CEOs, CEO age, CEO confidence, and CEO in the democrat party are most founded positive relation with corporate ESG performance [27].

3.1.2. ESG Compensation Structure

Determining reasonable compensation contracts is the core content of corporate governance [28, 29]. The current ESG indicators are regarded as leading indicators of future financial performance, and companies that adopted ESG indicators show high volatility. It is challenging to effectively measure and quantify ESG metrics such as employee satisfaction, carbon footprint or sustainable sourcing. In addition, classifying non-financial indicators as soft indicators tends to overlook their importance [30]. However, Ikram et al. state that introducing discretion or subjectivity into social responsibility is effective [31]. Gibbs et.al argue that subjectivity can improve contractual incentives by allowing for the inclusion of value-added efforts that are not easily quantified [32]. This subjectivity mitigates distortions when objective indicators or performance are noisy or imperfect. How to develop ESG indicators consistent with strategic objectives is an issue that enterprises should pay attention to, otherwise, inappropriate indicator selection will distract the CEO’s attention from strategic objectives.

Executive compensation is typically measured as the sum of cash compensation (salary and bonus) and equity compensation (payouts from the stock option, restricted stock, and long-term incentive plans), and measuring executive compensation performance based on a single compensation dimension is difficult because both types of compensation are benchmarked against different types of company performance. Most research observes that ESG performance is mostly tied to short-term bonuses and only a small proportion of companies link ESG to long-term incentives. Related ESG compensation studies estimate the proportion of ESG indicators in total compensation from the information disclosed by enterprises, inferring the incentive effect and the realization of ESG goals. Which structure can effectively exert governance effect is an open question.

Flammer et al. examine the S&P 500 that implemented ESG-linked compensation from 2004 to 2013 and find that ESG measures account for 4.2% of the average CEO’s total compensation [33]. They further find the CSR contract as a governance tool enables managers to focus on stakeholders who are less prominent but financially important in the long run, thereby enhancing corporate governance. The result is stronger when the proportion of compensation based on CRS is higher. Bechuk and Tallarita study that ESG compensation-related indicators disclosed by S&P 100 account for only 1.5% to 3% of the total CEO compensation, pointing out the limitations of the selection of ESG indicators on stakeholder commitment and the neglect of agency issues, that is, more indicators serve senior executives [34]. Walker further explores the same subsamples of Bechuk and Tallarita and explains that ESG-related annual bonus which is only a small fraction of annual pay is either widow-dressing or that directors fail to subscribe to the standard economic approach to executive incentives [35].

3.2. External Governance

From the perspective of external governance, engagement, investing and trading by institutional investors, ESG agencies and disclosure requirements by regulators strengthen supervision of ESG compensation.

3.2.1. Institutional Investors

Tang and Song indicate that institutional investors are motivated to engage in corporate governance to decrease agency costs and improve corporate financial performance [36]. Velte and Obermann believe that when ESG performance gets worse, Sustainable Responsible Investors (SRIs) are more likely to increase Say on Pay dissent [37]. Voting against CEO compensation will negatively impact the reputation of the firm and decrease the attraction of investors. As financial stakeholders, institutional investors have the incentive to monitor management behavior using muti-attribute

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functions related to the company's financial and ESG performance [38]. Thus, institutional investors with large equity shares have a significant restriction effect on the ESG performance of CEOs.

Several studies focus on the relationship between institutional ownership and corporate ESG profile (ESG scores). Gillian et. al. find that when firms improve ESG scores, institutional ownership decreases [39]. However, Azar et al. find a significant negative relationship between the ownership of Big Three (BlackRock, Vanguard, and State Street Global Advisors) and the subsequent carbon emissions of the MSCI index constituents, indirectly indicating that positive governance effect on the ESG-related issues by institutional investors [40]. The different conclusion requires further research into the preference and impact of these investors and their impact on ESG performance may be dynamic.

Currently, little is known about how the ESG goals of institutional investors affect executive compensation schemes. Furthermore, the influence of ESG-based remuneration by different types of investors is unknown.

3.2.2. ESG Rating Agency

ESG rating agencies have an indirect effect on the governance effect of ESG compensation of executives. When ESG-linked compensation does not match ESG ratings, investors or non-investment stakeholders have reason to believe that the CEOs seek rent by using ESG metrics in salary packages or the company has greenwashing behaviors. However, sustainability institutions aim to measure corporate ESG profiles with varying results and low correlations among all participants mainly because they have different viewpoints of ESG performance [41] and limited quality of ESG disclosure [42]. There is a risk of reducing environmental and social issues to quantitative metrics by using ESG scores alone to represent an organization's CSR practices. However, ESG rating agencies, as external regulators, have relatively little research on executive compensation contracts.

3.2.3. Disclosure Requirement by SEC

Better ESG disclosure can lead to tangible capital market benefits in the form of improved liquidity, lower cost of capital, increased firm value and potentially better corporate decisions [43]. The 2006 Executive Compensation regulations provide a good context for reviewing violations and enforcement for a variety of reasons. The rules require new detailed disclosures about executive pay. The SCE hopes these disclosures will help investors better understand and monitor companies' compensation practices (Cox 2006). These incentives are efficient because new legislation requires specific disclosure of incentive pay, benchmarking methods, and discretionary variable pay. However, some studies argue that companies with entrenched CEOs or weak governance do not respond to external pressure, and SEC's mandatory disclosure requirements may not prevent the restriction of CEO compensation [44].

4. Governance Results

The governance effect is divided into ESG performance and corporate financial performance in the following context.

4.1. ESG Performance

Studies are interested in the effect of ESG-linked executive compensation, but it is an open question. Some studies find a positive effect on ESG pay implementation. Companies that combine sustainability strategies with executive compensation enjoy better ESG performance and strengthen

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their stakeholder relationships [33]. Similarly, Cohen et al. conclude that ESG pay adoption is significantly negatively related to carbon emissions [19].

Several studies focus on how the sustainable compensation policy influences ESG performance, which is meaningful for corporate governance implications. Flammer et al. find that companies that adopt CSR objectives in their CEO compensation contracts increase their value, social environment, and green innovation [33]. Similarly, Tsang et al. use international datasets to show that linking CSR standards to executive compensation is associated with greater innovation output [45].

4.2. Corporate Financial Performance

Former academic research generally finds that ESG investment increases short-term costs but improves medium- and long-term performance. Friedea et al. review more than 2,200 empirical studies and conclude that about 90% of the studies shown non-negative ESG-CFP correlation [46]. However, some studies suggest that ESG has negative or no correlation with financial performance. This review only focuses on the CFP brought by the effect of ESG-based renumeration.

Derrien et al., (2021) conclude that the impact of ESG pay is still unclear currently [47]. Cohen et al. do not find that ESG-linked compensation brings about better financial performance, at least in the short run [19]. The specific reason why ESG pay does not play the expected governance effect deserves future study, which has important implications for enterprises to improve ESG executive compensation structure.

5. Conclusion

The inclusion of ESG metrics in executive compensation is part of the company's effort to improve sustainability and long-term value, measures the company's management of sustainability risks, and considers stakeholder actions and accountability on key sustainability issues. However, institutional background should be considered in evaluating the ESG compensation effect. For example, the consistency between "carbon emission" policy and economic development determines that ESG performance is limited by the economic development stage and industrial structure of the country. This review provides a research framework for the governance effect of ESG compensation and sorts out relevant research findings and research gaps from governance motivation, governance mechanism and governance effect.

In terms of governance motivation, a variety of theories show that incorporating sustainable development into strategy goals can significantly enhance long-term value. Although theoretically providing incentives for CEOs to design ESG compensation for rent-seeking, most empirical studies do not find this phenomenon. In terms of governance mechanisms, existing studies show that most companies incorporate ESG into the short-term compensation of executives and question whether the adoption of ESG incentives is window-dressing. Regarding governance results, a recent study finds that the adoption of ESG pay promotes ESG performance, especially in reducing carbon emissions while has no significant impact on financial performance in the short run. How ESG performance translates into financial performance is a concern of the industry and academia. As a lever of corporate governance, ESG-linked compensation is an effective means for enterprises to enhance long-term value. The improvement of information disclosure in the future will greatly promote the progress of ESG compensation governance practice and theoretical research.

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