Driving Climate Change through Executive Compensation

At the Climate Ambition Summit in December 2020, UN Chief Antonio Guterres called on world leaders to declare a State of Climate Emergency in their countries until carbon neutrality is achieved. To emerge stronger from the COVID-19 pandemic, he urged countries to adhere to a green and resilient pathway by calling for investments in green jobs, refusing bailouts to polluting industries, ending fossil-fuel subsidies, and factoring climate risks into all financial and policy decisions.

In this light, 2021 has witnessed unprecedented calls for commitment, action and investments not only from states but also from businesses and civil society groups. As per CDP India report 2020, 220 Indian companies disclosed climate change goals to investors and customers; an increase of 17% over previous year. For the first time, four Indian companies made it to the CDP A list (Hindustan Zinc Limited, IndusInd Bank, Mahindra & Mahindra and Tech Mahindra). Additionally, large Indian corporate houses Reliance Industries and JSW energy have taken voluntary commitments to go carbon neutral by 2035 and net zero by 2050.

Translating these global targets to a national or industry level is not easy. Interventions from regulators and policymakers can be expected but until then, organisations have a responsibility to try to reduce their carbon dioxide (CO2) and other greenhouse gas (GHG) emissions.

Climate change poses three main types of risk – physical, transition, and liability risks.

- Physical risks are related to events such as droughts, floods, hurricanes, extreme rainfall. Businesses have borne the significant brunt of acute events; for example, floods and hurricanes disrupting operations, as well as chronic, long-term changes to weather patterns such as rivers changing courses or fresh-water levels dropping.
- Transition risks include potential regulatory and policy changes (for example, mandatory carbon pricing which would increase a company's cost of capital), market reputational impacts, technology obsolescence, supply-chain disruptions, and changing consumer and employee preferences.
- Liability risks include product liability claims brought by states, cities and activists, as well as claims against businesses for failing to adapt to a transition to a low-carbon economy or failing to heed professional advice on physical risks' impacts on supply chains, infrastructure and processes.

These risks can impact long-term sustainability of businesses, hence the time to act is now.

What can Boards do – the role of executive compensation

Boards have the key role of setting expectations for the Management and reward them for delivering the desired performance whilst demonstrating the right behaviours. One big lever that they have to drive any agenda is

through executive compensation.

Principle 6 of the World Economic Forum's Principles for Climate Governance specifically calls out for executive incentivisation on climate-related targets and indicators. Increasingly, compensation committees are also viewing climate and other ESG issues as top business priorities and are incorporating these goals in performance management and executive incentive plans.

An analysis conducted by Willis Towers Watson in 2020 shows that approximately 11% of top 350 European companies have disclosed linkages between CO_2 emissions to their long-term incentive plans. This issue is still in early stages in India, but several progressive companies are considering adding explicit carbon-related targets in executive incentive plans. We expect to see many more companies purse this over the coming year.

Is there a standard metrics to measure CO_2 emissions?

All the key greenhouse gasses are converted to their CO_2 equivalents, and tCO_2e (or tonnes of CO_2 equivalent) has emerged as the standard measure of emissions as used in all Climate Change discussions and reporting.

tCO_2e emissions goals can be classified under three scopes. Scope 1 is direct emissions from owned and controlled resources, Scope 2 is indirect emissions from sources of purchased electricity and Scope 3 is all indirect emissions along the company's value chain, including suppliers, customers and partners. While most companies focus on Scopes 1 and 2, which they can directly influence, progressive companies also focus on Scope 3 and influence supply-chain partners to further reduce emissions

Implementing CO_2 emissions driven incentive arrangements may not be straightforward. Should the consideration be through STI or through LTI and how goals are to be set is important.

Call to action

Organisations should focus on having the relevant systems that can measure and track carbon emissions, set clear and stretched reduction targets and then align executive compensation plans with these goals. It is important, though, to understand the substantial maturity required when thinking about incorporating CO_2 emission reductions in executive compensation.

On climate change, now is time to time to act unilaterally and not let the future generations bear the brunt of inaction and delay.

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About the Authors:

Shai Ganu
Managing Director – Global Leader, Executive Compensation
Willis Towers Watson
Shai.Ganu@willistowerswatson.com

Rajul Mathur
Head - Talent and Rewards, India
Willis Towers Watson
Rajul.Mathur@willistowerswatson.com

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