Market Study

ESG Factors in Management Remuneration

Freshfields Bruckhaus Deringer

Introduction

In recent years, the integration of environmental, social, and governance (ESG) factors into business practices has become increasingly important for sustainable value creation and key for corporate long-term success. Management remuneration is a critical means through which companies can influence organisational behaviour and performance – investors, regulators and other stakeholders are clear that aligning management remuneration with ESG objectives is a must for listed companies from a German perspective.

Our study sheds light on the multifaceted relationship between ESG-related criteria and management remuneration. We explore the following questions:

- Which types of ESG-related criteria do we see in management remuneration in listed companies?
- How are ESG-related criteria utilised? In short-term or long-term incentives (or both)? As a standalone criterion or as a multiplier?

Our findings are accompanied by an outline of the legal landscape and an overview of the expectations of proxy advisors, shareholders and other stakeholders.

Framework

Legal landscape

Arguments continue as to whether or not it is mandatory under the law to include sustainability aspects as a factor in management remuneration in Germany. Changes to the German Stock Corporation Act (as part of the implementation of the EU's Second Shareholder Rights Directive or SRD II) suggest that, at a minimum, ESG factors need to be taken into account. On the other hand, based on the explanatory notes of the legislative draft, it can be argued that there is no strict obligation under the law.

Sustainability-related obligations are also included in the German Corporate Governance Code (GCGC). The principles of the GCGC state that the remuneration structure of listed companies must be oriented towards the company's sustainable and long-term development, with "sustainability" referring to both environmental (ecological) and social goals. However, the GCGC only requires a 'comply or explain' approach, meaning deviations from the recommendations are legally permissible but must be disclosed in the declaration of conformity.

Despite the opaqueness of the laws, over recent years many listed companies have started to integrate ESG-related criteria into their business strategy and management remuneration in order to meet the growing demands and expectations of society and (supposedly) investors.

Expectations by proxy advisors and other stakeholders

Some institutional investors and proxy advisors have made a specific commitment to consider sustainability-related criteria. For example, Allianz Global Investors expects large companies in developed markets to include ESG-related criteria in their remuneration structure and will generally vote against the approval of remuneration policies that do not include ESG-related criteria; from 2025 they will also apply this rule to smaller companies in developed markets.

Proxinvest also recommends that performance-related board remuneration should include at least one ESG-related performance component, whilst Union Invest expects ESG-related criteria to be explicitly included in long-term variable remuneration. Ethos advocates that the annual bonus and long-term equity plans of the management board should take into account how well the company performs on environmental and social issues.

ISS and Glass Lewis are more differentiated when it comes to ESG-related criteria: they state that sustainability targets are generally to be supported but also emphasise that these must not interfere with the requirements for general corporate success. Therefore, the individual circumstances of the company must be considered if ESG-related criteria are set.

Market and scope

Factual landscape of ESG in management remuneration

Whilst the trend towards taking ESG-related criteria into account is unmistakable, no standard has yet evolved for practical implementation within remuneration policies and service agreements of management. In practice, the picture is inconsistent. The metrics chosen are still characterised by great restraint – the financial impact of the sustainability elements is still relatively low compared to the criteria linked to key financial figures.

Scope of reviewed companies

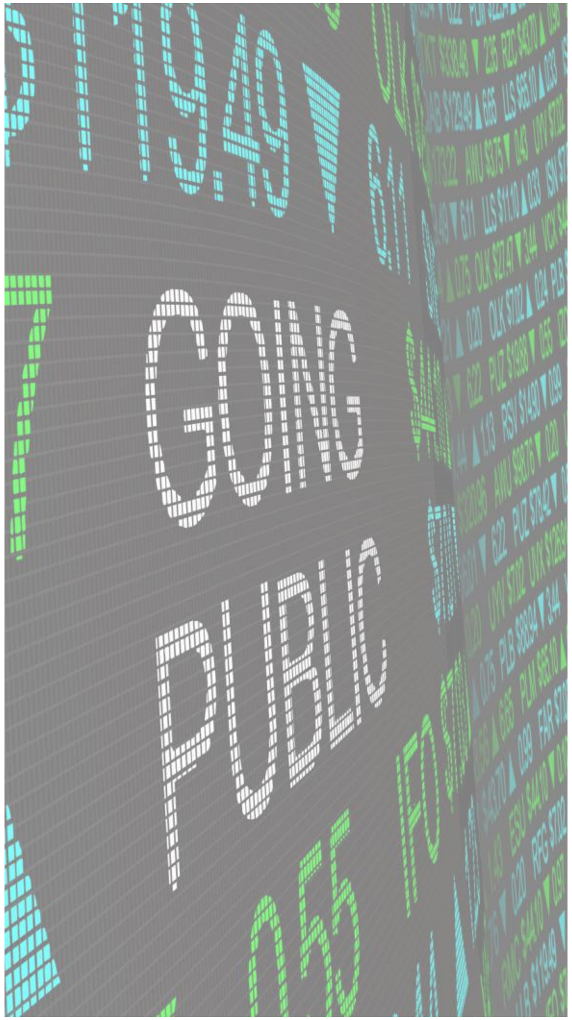
Our study considers data of all companies listed in the DAX (*Deutscher Aktienindex*), the MDAX and the TecDAX.

The DAX is the premier stock market index in Germany, representing the 40 largest and most liquid publicly traded companies on the Frankfurt Stock Exchange. It serves as a key benchmark for the performance of the German stock market and the broader economy. The DAX includes well-known multinational corporations such as Siemens, Volkswagen, and Deutsche Bank.

The MDAX is a German stock market index that tracks the performance of 50 mid-sized companies listed on the Frankfurt Stock Exchange, sitting just below the DAX in terms of market capitalisation. It includes companies from various sectors, providing a broader view of the German economy beyond the largest corporations.

The TecDAX is a stock market index in Germany that tracks the performance of the 30 largest technology companies listed on the Frankfurt Stock Exchange. It includes innovative firms from sectors such as software, biotech, and telecommunications. The TecDAX serves as a key indicator for the tech industry in Germany and complements the broader DAX index by focusing on the high-growth technology sector. It should be noted that 20 of the 30 TecDAX companies are already represented in the DAX or MDAX.

Overall, our study incorporates data from 100 companies listed in Germany.



Underlying data

The data in this study is taken from the companies' publicly available remuneration policies and reports. According to German law (based on SRD II), German listed companies must: (a) provide a remuneration policy that applies to the members of the management board; and (b) publish a remuneration report which contains details on management remuneration in practice.

Whilst remuneration reports must be published on an annual basis, remuneration policies can be in force for up to four years. If the company's supervisory board elects to make material changes to management remuneration, this must be reflected in a new remuneration policy.

The remuneration reports we reviewed mainly provide data for the financial year 2023. However, in the very few cases the remuneration report for 2023 was not yet available, the report for 2022 was assessed instead.

This study assesses the most recent remuneration policies (as per the cut-off date of 30 April 2024). For the DAX companies, 50 per cent of these policies dated from 2023 or 2024, and the other 50 per cent from 2020, 2021 or 2022. The high number of newer remuneration policies is not surprising as most companies published their first remuneration policies in 2020 and, as a result, had to renew their remuneration policies in 2024 at the latest. With respect to the MDAX and TecDAX, the picture is very similar.

Foreign companies listed in Germany are not required by law to issue a declaration of conformity with the GCGC or to comply with the German statutory rules on remuneration policies, though they may be subject to similar rules in their home jurisdiction. As the number of foreign companies during the assessed period was low, and information on remuneration and sustainability targets could be found in most cases, they have been included in this study (without special reference being made).

The cut-off date for the data for the study in relation to the companies listed in Germany was 30 April 2024.

ESG-related criteria used by listed companies

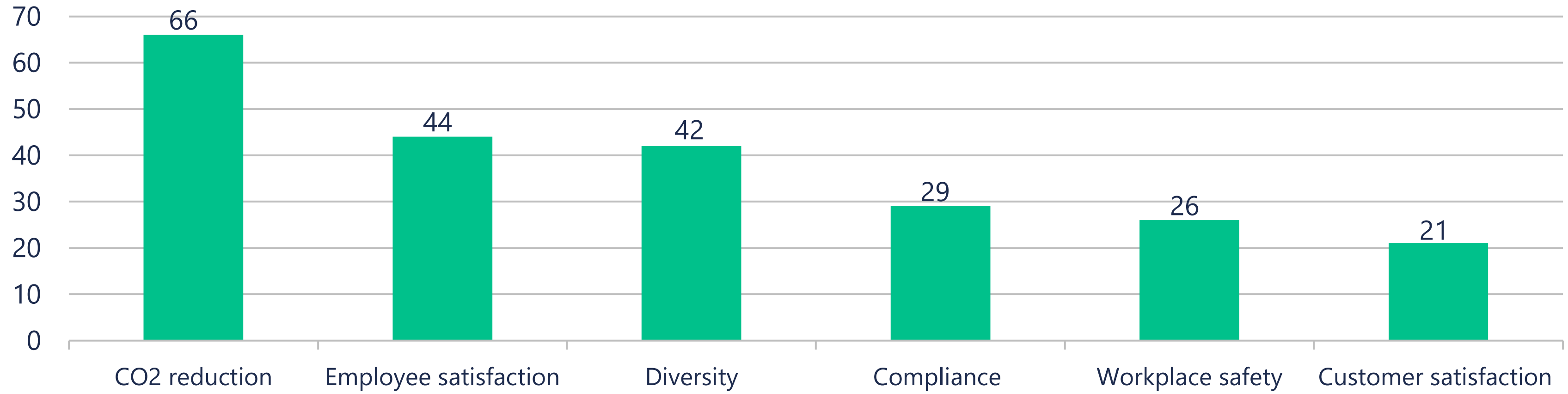
Overview

Overall, the ESG-related criteria of listed companies in Germany are very similar across the indices.* The most used ESG-related criterion is CO_2 reduction: 66 of the 100 assessed companies refer to CO_2 reduction as one of their ESG-related targets. This is followed by employee satisfaction and diversity, with a significant number of companies referring to compliance, workplace safety and customer satisfaction.

It is debatable whether employee or customer satisfaction should count as ESG-related criteria, if ESG is interpreted as the company's impact on society, the environment, and governance practices. Both employee and customer satisfaction are core interests of a successful business with little broader impact. Their importance to a company's core interests may be a reason why, even though the link to sustainability may be questionable, employee and customer satisfaction are among the six most popular ESG-related criteria among companies listed in Germany.

The diversity criterion generally refers to increasing the diversity of the company's own workforce across all diversity factors. However, the most popular of the diversity sub-criteria is increasing the number of women in management and senior positions.

Workplace safety summarises the criteria companies publish relating to the number of workplace accidents and the decrease of workplace accidents. While the terms 'workplace safety' and 'diversity' are comparably specific, the term 'compliance' is relatively broad. 'Compliance' includes targets aimed at decreasing the number of compliance breaches, but also covers objectives for setting up and maintaining effective systems to ensure compliance with specific laws (e.g. data protection laws).

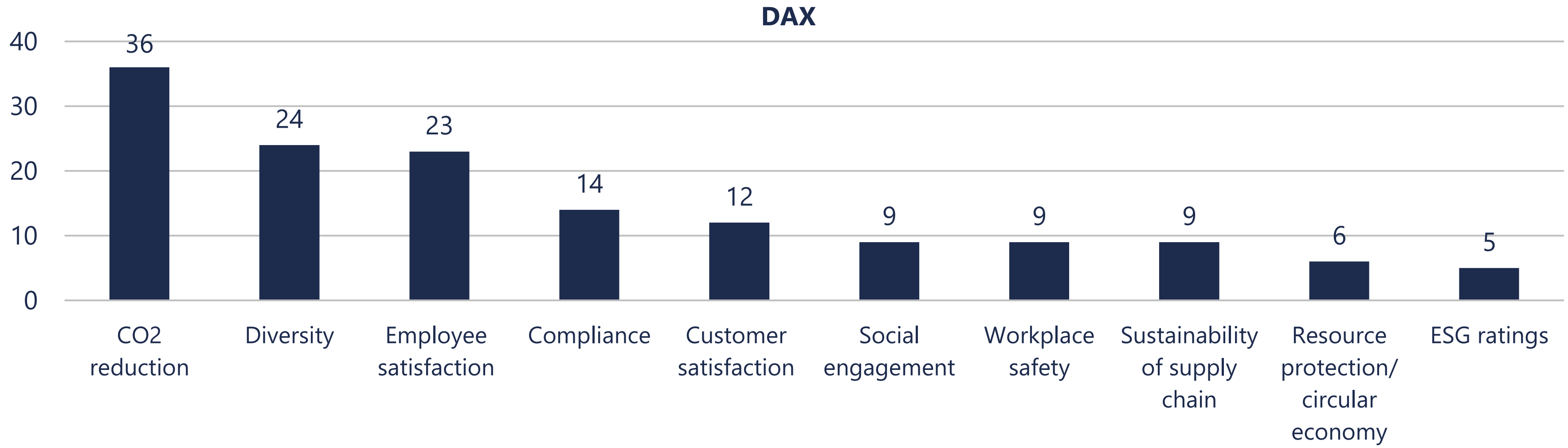


*For purposes of this study we have chosen generic terms to categorise ESG-related criteria. Accordingly, the terms used to describe ESG-related criteria in the following are to be understood broadly.

ESG-related criteria used by listed companies

DAX

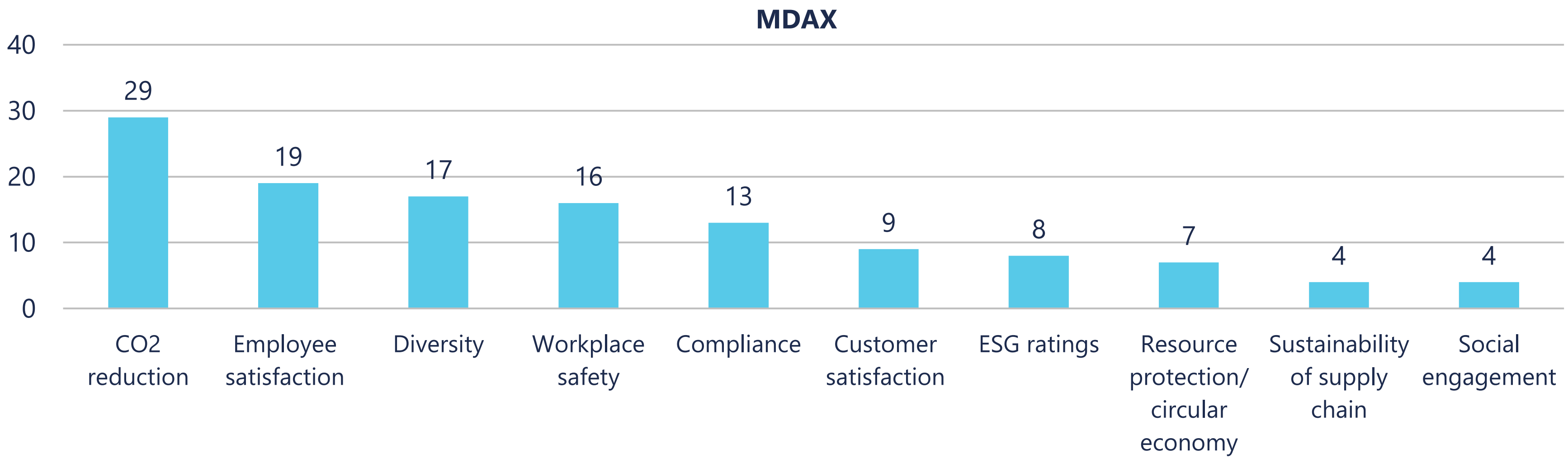
For the DAX, the graph of the six most popular overall ESG-related targets of the assessed companies is very representative of the overall total, except that targets relating to workplace safety are less popular than within the MDAX and social engagement is within the top six. In addition, ESG-related criteria relating to supply chain sustainability, resource protection/circular economy and ESG ratings can be found. Examples of social engagement criteria include targets relating to the number of cooperations with companies/farmers from low-income countries and access to health products.



ESG-related criteria used by listed companies

MDAX

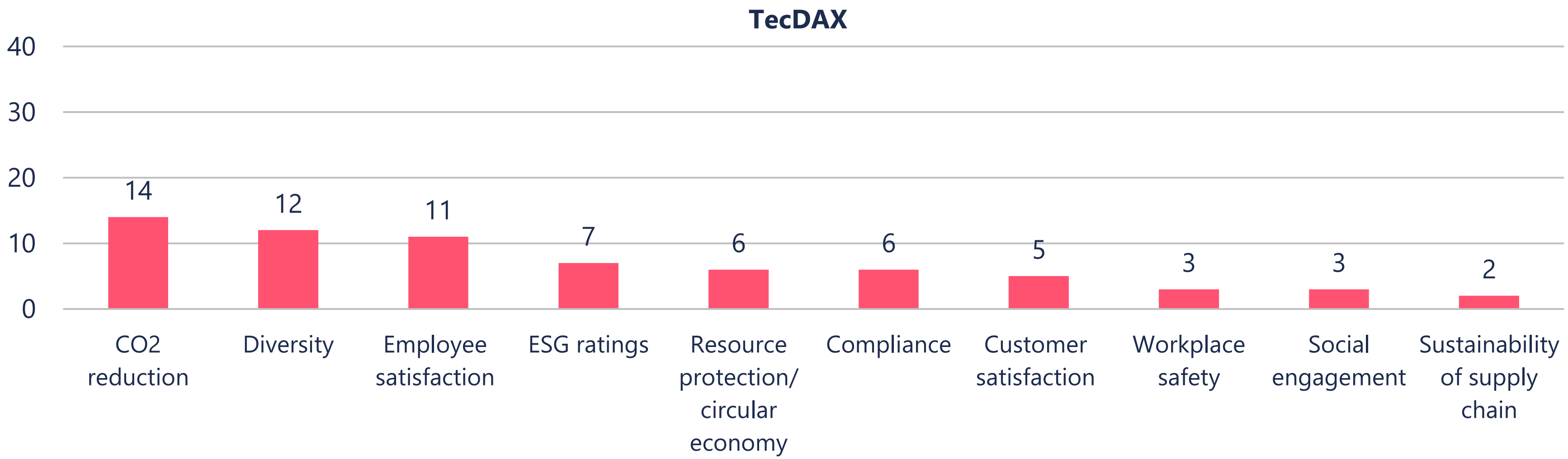
With regard to the MDAX, there are no noteworthily different criteria, although the focus is somewhat different. The top three criteria are the same as in the DAX, with employee satisfaction being slightly more popular than diversity and CO2 reduction at the top. However, in fourth place is workplace safety, which a significant number of companies refer to. A possible explanation is that within the MDAX, the number of companies in the industrial/production sector is higher so that it may be assumed that on average, workplace safety is more relevant. Workplace safety is followed by other ESG-related criteria also common in the DAX, namely compliance, customer satisfaction, ESG ratings, resource protection/circular economy, social engagement and supply chain sustainability.



ESG-related criteria used by listed companies

TecDAX

TecDAX companies also have CO_2 reduction, diversity and employee satisfaction as their top three criteria. In fourth place among TecDAX companies, however, is the company's result in ESG ratings as an ESG-related criterion, followed by resource protection/circular economy, compliance, customer satisfaction, workplace safety, social engagement and supply chain sustainability.

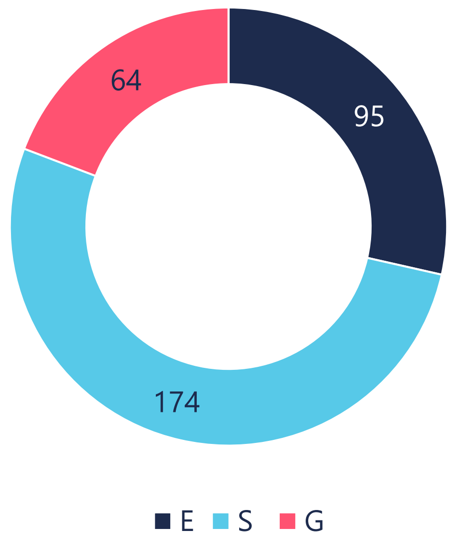


Environmental, social, governance

While CO_2 reduction is the most frequently used ESG target, the vast majority of the ESG-related criteria used by companies listed in Germany can be characterised as falling within the 'S' criteria. This is mainly due to the fact that diversity, as well as customer and employee satisfaction, are very prevalent and fall in the 'S' category.

Apart from CO_2 reduction, the 'E' category only has one other commonly used criterion, which is resource protection/circular economy. Depending on the wording of the specific target, supply chain sustainability may count as an environmental criterion as well. However, for the purposes of this overview, it has been categorised as falling into the 'G' category as a compliance and risk target.

Criteria from the 'G' category are the least popular and it seems there is some uncertainty as to what would be considered "governance". Also, the overlap with "social" is not clear cut. For example, most companies consider diversity to be "social" while a few qualify it as "governance". Similarly, workplace safety could be considered both as a "social" factor and a "governance" factor. While workplace safety does have governance aspects (oversight, risk management and compliance), in this context it seems to be primarily a social issue focusing on employee wellbeing and responsible human capital management as it refers mainly to the number (or decrease in number) of workplace accidents. Typical governance targets include various aspects of compliance such as reduction of breaches, enhancing compliance systems and risk management.



It should be noted that, in practice, little attention is given to whether companies provide for criteria of all three categories. Accordingly, companies might choose to focus on finding ESG-related criteria that support or complement their core business rather than checking all ESG boxes.

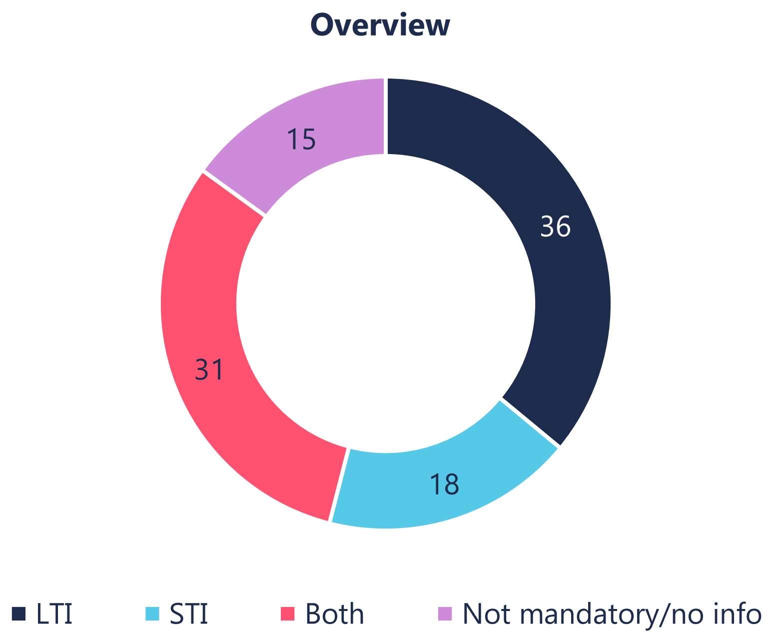
How listed companies use ESG-related criteria

LTI, STI or both?

Most companies provide the option to consider ESG-related criteria in the context of both short-term incentives (STI) and long-term incentives (LTI), and 31 per cent require that ESG targets are mandatorily reflected in both variable compensation components. Overall, however, ESG-related criteria are most often considered mandatory as part of the LTI (36 per cent). Nonetheless, 15 per cent of the assessed companies for Germany do not provide for mandatory ESG targets within the variable compensation at all.

The vast majority of the assessed companies acknowledge ESG-related criteria as a standalone component within the respective categories of variable compensation.

The weighting of the ESG-related criteria differs significantly from company to company; the percentage of total variable compensation that ESG-related criteria can affect ranges from 5 per cent to 40 per cent across the assessed companies.



How listed companies use ESG-related criteria

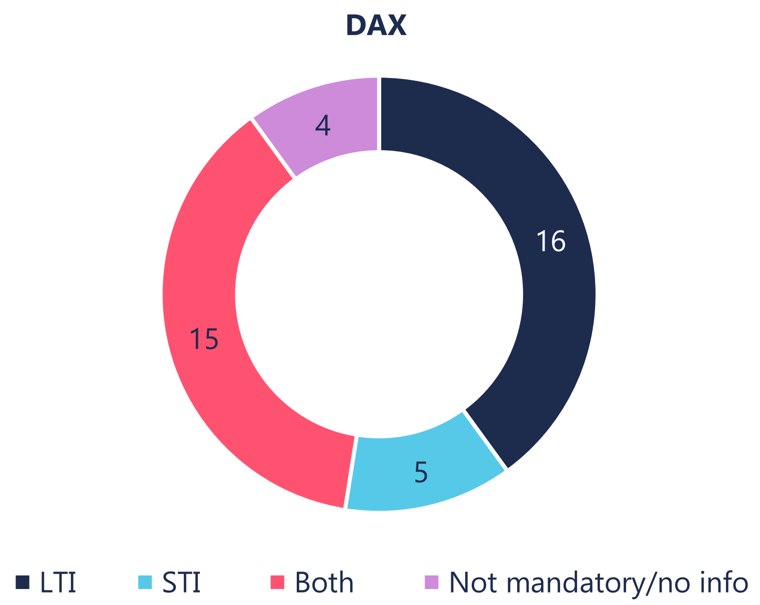
LTI, STI or both?

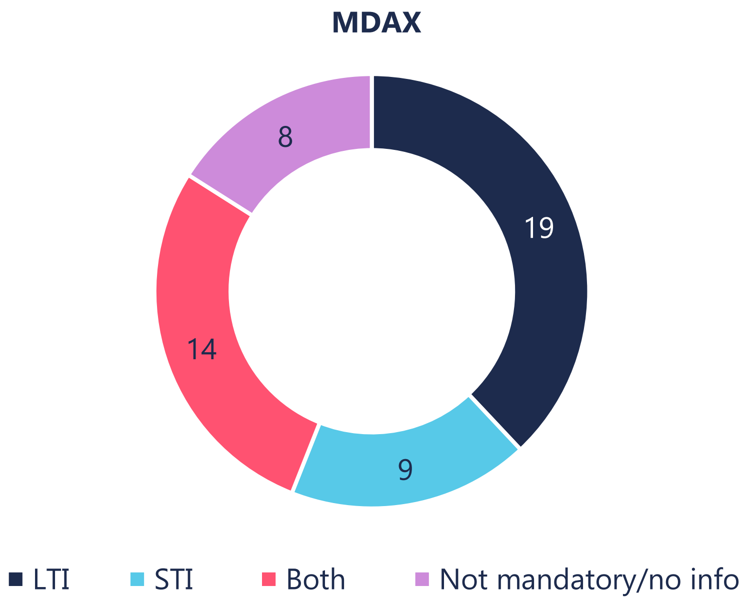
DAX

Of DAX companies, 40 per cent provide for mandatory ESG-related criteria in the LTI, approximately 38 per cent in both variable compensation components and only approximately 13 per cent in the STI. Only 13 per cent do not consider ESG-related criteria to be mandatory.

MDAX

The portion of MDAX companies considering ESG-related criteria a mandatory part of the LTI is 38 per cent, whereas 28 per cent consider it mandatory as part of the STI and the LTI, and 18 per cent require ESG-related criteria in the STI. Another 16 per cent do not provide for ESG-related criteria at all or consider them voluntary aspects within the variable compensation scheme.



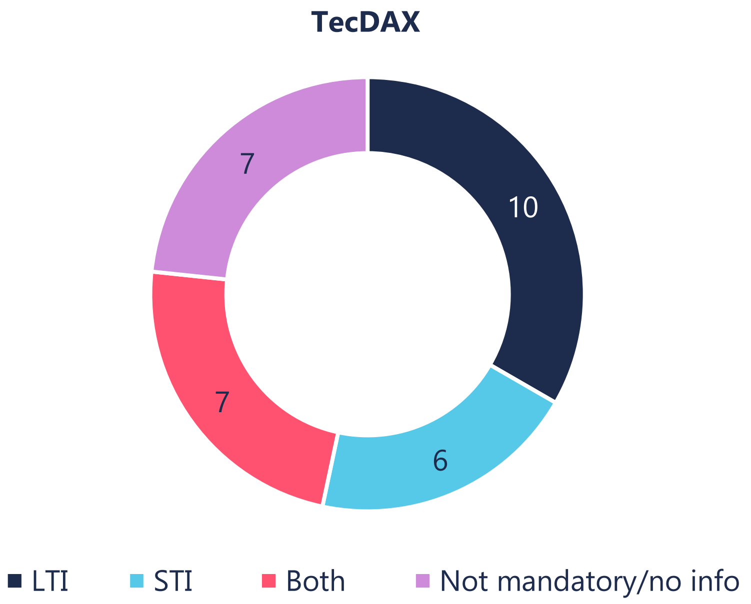


How listed companies use ESG-related criteria

LTI, STI or both?

TecDAX

A third of the TecDAX companies include mandatory ESG-related criteria in the LTI. Approximately 23 per cent require ESG-related criteria in both the LTI and the STI, and 20 per cent require ESG-related criteria in the STI. Interestingly, 27 per cent of the companies listed on the TecDAX do not consider ESG-related criteria to be mandatory as part of the variable compensation.



ESG-related criteria mainly reflected in the LTI

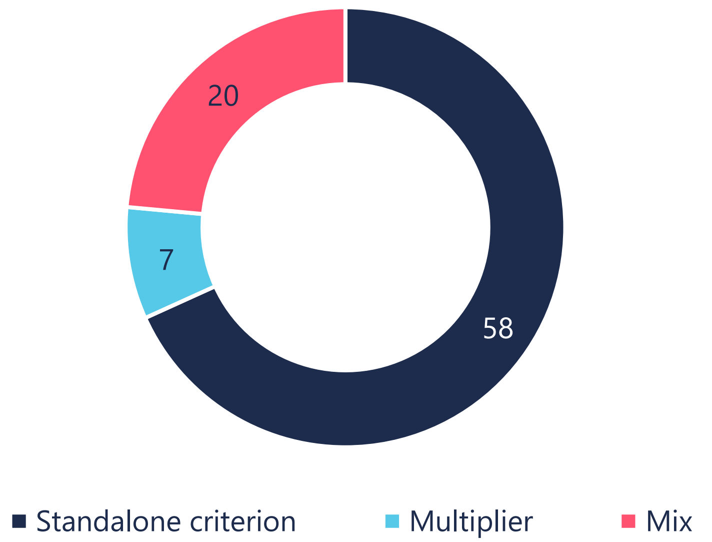
A reason why ESG-related criteria are predominantly reflected in the LTI may be because ESG initiatives often require substantial time to plan, implement and show results. For example, effects such as achieving a reduction in CO2 emissions or improving workforce diversity typically unfold over several years. Considering this, having ESG-related criteria impact the LTI rather than the STI seems a logical starting point. However, once an ESG initiative is implemented, results may be achieved in much shorter timeframes as well. This may be the reason why a substantial number of companies provide for the flexibility to consider ESG-related criteria in long- and/or short-term variable compensation.

How listed companies use ESG-related criteria

Standalone component or multiplier?

The consideration of ESG-related criteria within the incentive arrangements (standalone component or multiplier) is relatively uniform across the indices.

Only 7 per cent of the assessed companies consider ESG-related criteria as part of the variable compensation by way of a multiplier. If a multiplier is utilised, it is usually set between 0.8 and 1.2. Few companies provide for a combination of a standalone criterion and multiplier, and generally this is only used when they include different ESG-related criteria or when ESG-related criteria are included in both the LTI and the STI.



(15 of the assessed companies do not provide for mandatory ESG-related criteria or no information was available)

How listed companies use ESG-related criteria

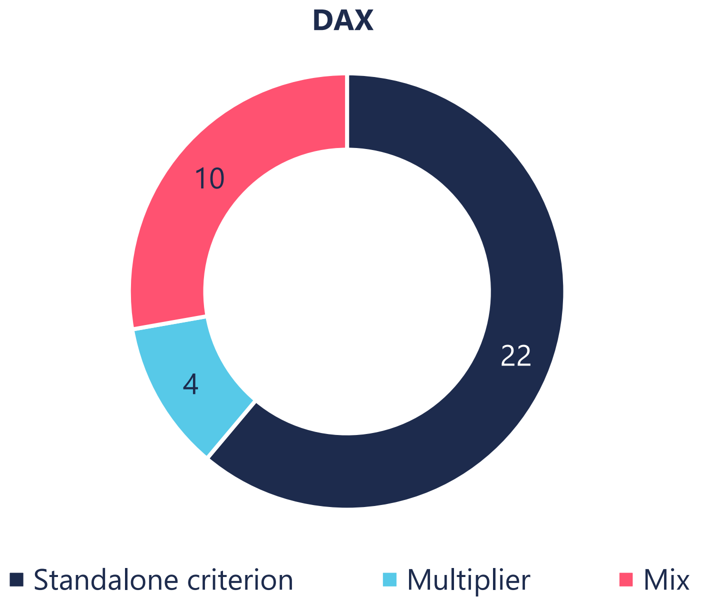
Standalone criterion or multiplier?

DAX

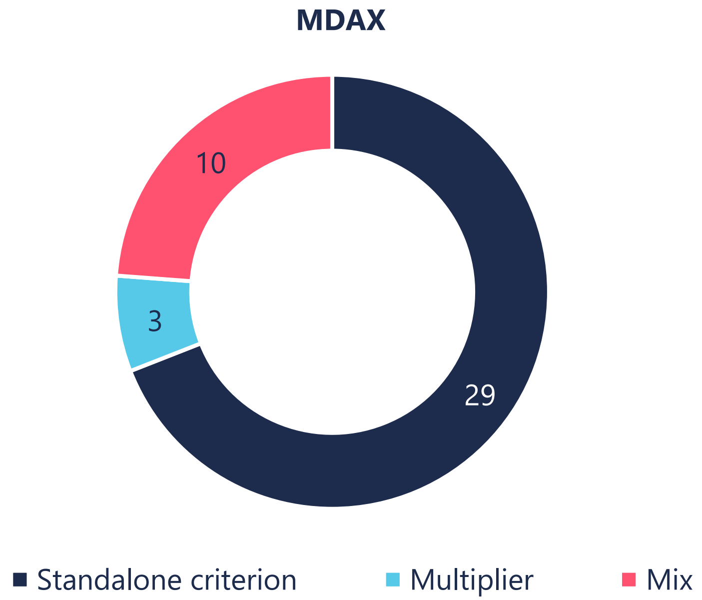
55 per cent of the DAX companies provide for ESG-related criteria as a separate individual part of the variable compensation and only 10 per cent use a plain multiplier.

MDAX

As regards the MDAX, the share of companies considering ESG-related criteria as an individual component is comparably high at 58 per cent. Only 6 per cent of the relevant companies employ a plain multiplier.



(4 of the assessed companies do not provide for mandatory ESG-related criteria or no information was available)



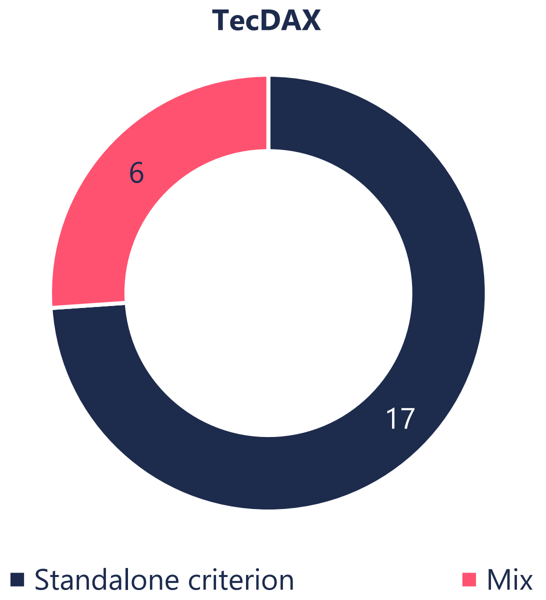
(8 of the assessed companies do not provide for mandatory ESG-related criteria or no information was available)

How listed companies use ESG-related criteria

Standalone criterion or multiplier?

TecDAX

Approximately 57 per cent of TecDAX companies consider ESG-related criteria as individual components, while none employ only a multiplier.



(7 of the assessed companies do not provide for mandatory ESG-related criteria or no information was available)

Reluctance to use a multiplier

A reason why the vast majority of companies provide for a separate ESG component within the variable compensation instead of employing an ESG multiplier to the STI or the LTI may be that multipliers generally trigger wariness of stakeholders, including proxy advisors. In the past, multipliers were often used as a means to retain flexibility in adapting bonuses, and the criteria were not always transparent.

As a result of growing criticism against this practice, companies have become more cautious with respect to multipliers. However, such criticism would not be justified (and may therefore be avoidable) if clear targets are set and the multiplier is determined in a transparent manner.

Another likely reason for the aforementioned reluctance is that a multiplier can have a more significant influence on the overall bonus figure, in particular if the target achievement with respect to the other criteria is already good or exceptional. As a result, the multiplier approach may lead to disproportionate changes in variable compensation that might not correspond directly to the importance associated with ESG performance.

On the other hand, a multiplier approach could prevent a situation in which the financial targets or 'pure' company business targets were not met, and still a material bonus would have to be paid for achievement of ESG targets. We have seen examples of this in practice. In these cases companies were severely criticised in public, showing that, while ESG is important for stakeholders in Germany, it is still more important that the business is performing well.

Summary and outlook

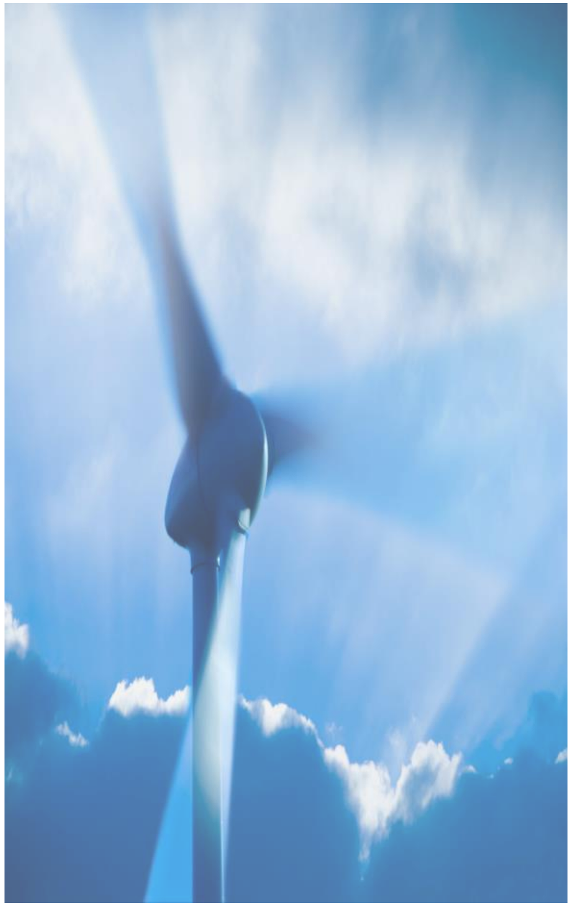
In conclusion, listed companies in Germany currently still only use a relatively limited set of ESG targets to feed into remuneration expectations. CO_2 reduction is particularly notable as the most frequently used ESG-related target, likely due to the fact that it can be considered a relevant environmental target for most companies and is easy to measure. While CO_2 reduction is not necessarily complementary to most companies' core business, the risk of it clashing with a company's core business is also relatively small, thereby making it a 'safe bet'. The same applies for improved diversity within the workplace as an ESG-related criterion. Without diminishing CO_2 reduction and the promotion of diversity as ESG-related criteria (as well as the importance of the underlying motivations), it seems desirable from a stakeholder's perspective to also find ESG targets that complement the company's core business.

Based on our analysis there is no clearly discernible trend as to whether the importance of ESG factors in management remuneration will decline or grow further in the future, nor can any trends be discerned with respect to new or different ESG-related criteria. Approximately 28 of the examined companies in the different indices have made ESG-related changes in their 2022 or 2023 remuneration policies, but the changes introduced do not provide a sufficiently uniform picture to permit the prediction of a trend as to the design of ESG-related criteria. Instead, there is an impression that companies are, to a certain extent, still in the 'trial and error' phase when it comes to finding the ideal way to consider ESG factors in the context of management remuneration.

The identification of suitable ESG-related criteria is challenging. It is crucial to dovetail the remuneration structure with the corporate strategy and, in particular, with the company's sustainability strategy. Otherwise, there is a risk that a situation could be created where sustainability-related targets are diametrically opposed to the interests of the company. This may also be one cause for the frailty of the ESG trend in the US, as compared to Germany. Shareholders are less interested, or even opposed to, ESG targets within remuneration when such targets do not, on their face, help improve the company's business performance.

In a second part of this study, we will examine this aspect further when we cover the US landscape in respect to ESG-related criteria in management remuneration. The aim is to understand why ESG does not seem to have the same traction in the US as it has in Germany. For that purpose, we will, in particular, look into the following questions: Do European companies use different criteria, making consideration of ESG-related criteria in management remuneration and elsewhere more successful or sensible from a business perspective? Have allegations of corporate 'greenwashing' led to an overall negative image of ESG-related criteria? What role does the legal landscape play?

Meanwhile, in respect to listed companies in Germany, it can be safely stated that the goal in relation to ESG-related criteria in management remuneration should be to identify sustainability-related targets that – in a worst case – are neutral but ideally derive directly from the operations or business plan of the company and therefore contribute to the corporate success of the company.



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