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Climate targets, executive compensation, and corporate strategy

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With the 2015 Paris Agreement to limit global warming to well below 2 degrees, climate change has moved back up the policy agenda. Governments around the world are developing policies to help achieve global climate targets. At the same time, climate change—and wider environmental, social and governance (ESG) issues—have risen to board-level on the corporate agenda. Across the corporate sector, companies are reformulating their strategies for a climate-constrained world.

Pressure from institutional investors is an important driver of this process. Back in 2015, Mark Carney, as Governor of the Bank of England, warned the financial community about the implications of climate change for the value of investment portfolios. Over the last 2 years, investors have mounted pressure on listed companies to measure and disclose their exposure to climate change—and to formulate corporate strategies that are "Paris-consistent". A central role is played by investor coalitions like Climate Action 100+, a group with over $40 trillion in assets under management. Unlike national climate policy initiatives, investor-driven corporate climate action has global reach.

A novel aspect of the emerging corporate response is that executive compensation is starting to be aligned with company-level climate targets. In December 2018, Shell announced that it will from 2020 onwards tie the incentive pay of its CEO and senior management to company-wide carbon targets. BHP, one of the world's largest miners, also uses a climate target in its CEO pay; electricity companies are exploring similar ideas. Companies in other sectors like heavy industry and transport—including airlines, aluminum, cement and steel—will face similar questions. In short, carbon emissions are emerging as a driver of long-term corporate value—and companies are beginning to embed them in their management incentives as a key performance indicator.

The paper addresses the "what, why, and how?" of linking executive pay to climate metrics. The paper begins by explaining the rationale for corporate climate action to fill the "policy gap" left by governments. Then it presents an overview of climate-linked metrics in CEO incentive plans at BP, Chevron, ExxonMobil, Shell, and Total. Climate-linked metrics account for 8% of short-term incentive pay at these companies. A set of principles for incentive pay is developed through which to understand the benefits of including climate metrics in a balanced scorecard and the challenges in terms of incentive design. Finally, the paper comments on how the practice of linking executive pay to climate metrics might be refined over time as the measurement of carbon emissions along the value chain improves.

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