

# Labour Law Commission

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## ESG targets in (executive) remuneration

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# Agenda

1. Current (legal) framework
2. How to determine ESG goals
3. How to implement ESG goals in variable remuneration
4. Specification of ESG targets in the remuneration system
5. Conclusion Status Quo
6. Forecast



# 1. Current (legal) framework

Obligation to agree on sustainability goals?

*« In the case of listed companies, the remuneration structure must be designed to the sustainable and long-term development of the company. »*

§ 87 sec. 1 2<sup>nd</sup> sentence AktG

Principle 24 sec. 3 DCGK

- Supervisory board of listed companies is required to take sustainability into account ("take a close look") by choosing financial and, if necessary, non-financial criteria.
- Agreement on sustainability targets /ESG targets in variable remuneration



# 1. Current (legal) framework

Investor expectations



Allianz Global Investors	Union Investment	DWS	Capital Group
No approval of remuneration systems without ESG conditions	<p>The sustainability target</p> <ul style="list-style-type: none"> <li>• should be derived from the strategy</li> <li>• be measurable, transparent and verifiable, and</li> <li>• be embedded in the long-term variable remuneration.</li> </ul>	<ul style="list-style-type: none"> <li>• Significant part of STI and LTI to include ESG-related company-specific targets</li> <li>• Malus / clawback with ESG reference</li> </ul>	<p>Rejection of all shareholder resolutions implementing ESG targets in board remuneration</p> <p>→ Widespread scepticism in US about ESG targets</p>



# 1. Current (legal) framework

## Investor expectations

### Questions in Annual General Meetings 2023 of companies listed on the Stock Exchange

- Why are there no ESG targets in variable remuneration?
- When will you include ESG goals in the long-term variable remuneration?
- Are there ESG targets in the variable remuneration, for example in the long-term variable remuneration?
- Which targets are these, how strongly are they weighted and how is the achievement of the ESG targets measured?

2022 10%

2023 In DAX and MDAX, ESG targets in approx. **90 %** of remuneration systems



# 1. Current (legal) framework

## EU Sustainability Directive / CS3D

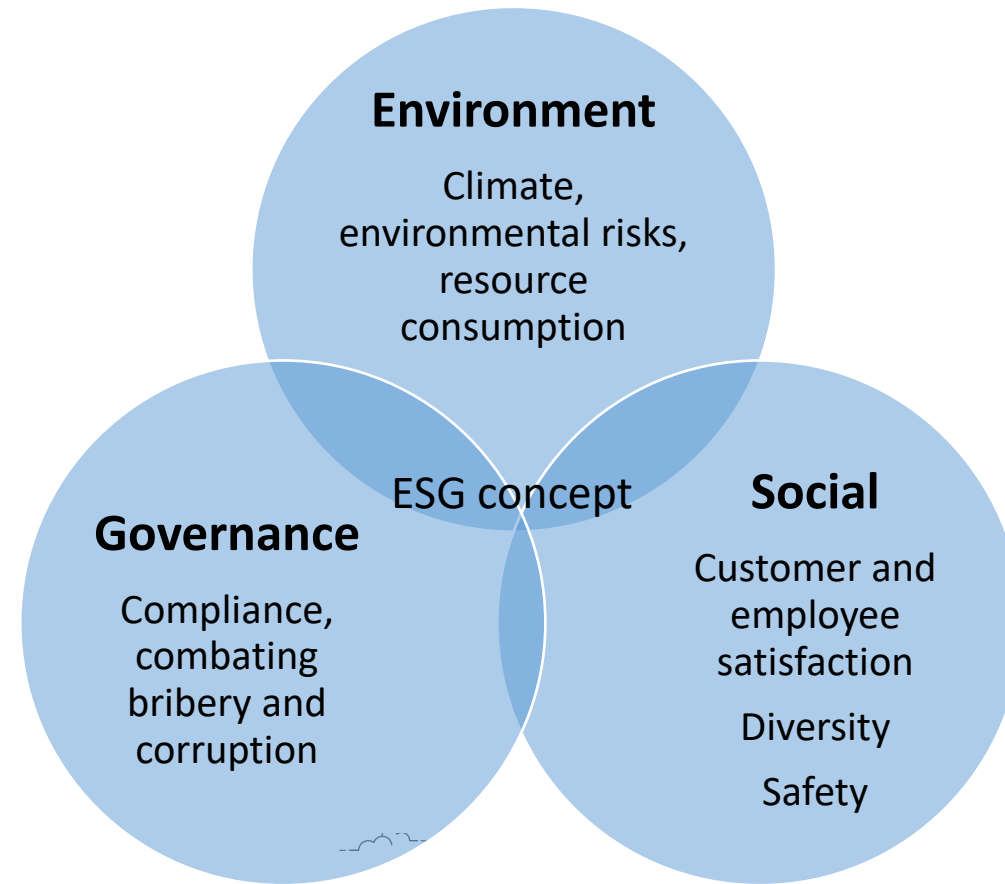
## **Proposal of EU Sustainability Directive / CS3D**

Consider climate targets in variable remuneration of management bodies (Art. 15 para. 3)?



# 2. How to determine ESG goals

The ESG concept



# How to determine ESG goals

Praxis Top 10 - source: Kienbaum 2022

## Environment (40%)

- Reduction of Carbon emissions (1)
- Sharpening the Sustainability profile (4)
- Sustainable products (8)
- Use of resources (9)

## Social (40%)

- Diversity (2)
- Employee satisfaction (3)
- Customer satisfaction (6)
- Work safety (7)
- Continuing education (10)

## Governance 20%

- Compliance (5)





# 1. How to determine ESG goals

## ESG in companies

### “Pay follows Strategy”

- Derive ESG goals from corporate strategy
- In transition phase ESG criterion "Develop a sustainability strategy" or "Develop an ESG target"

### Step 1: Clarify basic direction

### Have a look at your own sustainability reporting

- What is measured and reported?
- Are there any established key figures?



# 1. How to determine ESG goals

## Definition of objectives

Objective and measurable targets

Absolute or relative target definition ?

### Step 2: Definition of objectives

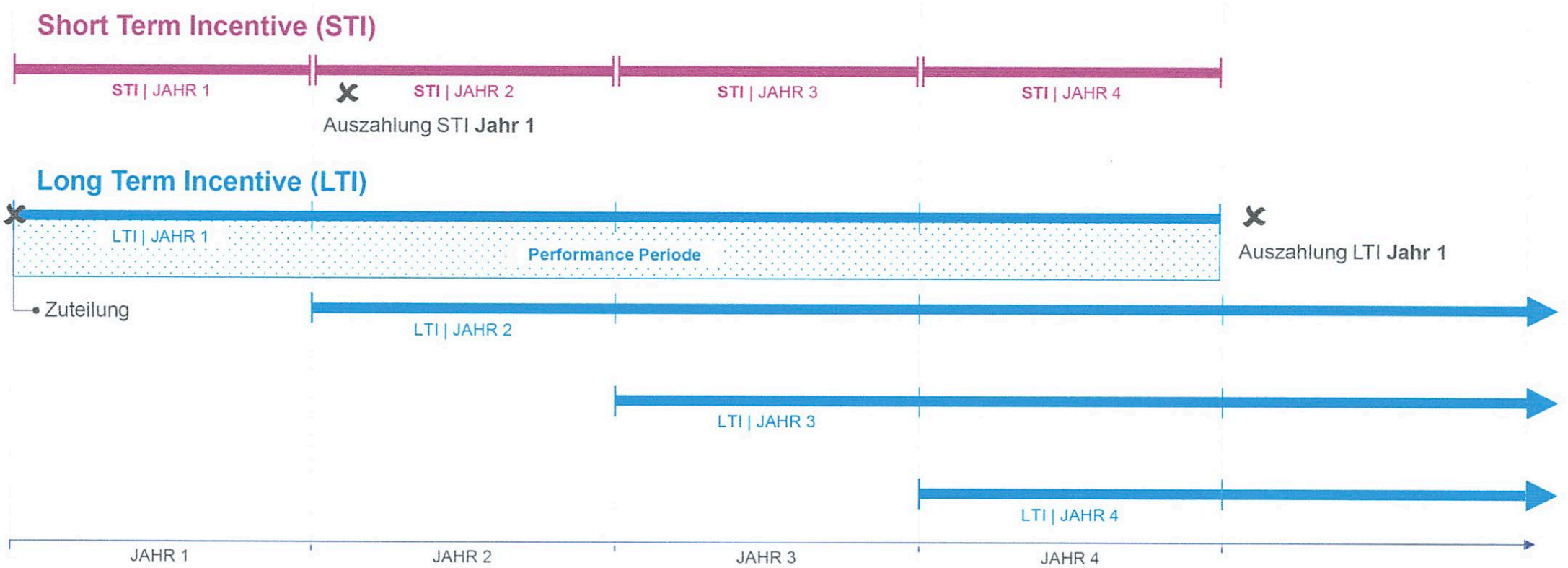
Do you rely on external ratings?

Overachievement/Cap?



# 3. How to implement ESG goals?

Concept of Executive Board remuneration according to DCGK 2020



# 3. How to implement ESG goals?

Short-term (STI) or long-term (LTI) incentive?

- No legal requirement
- Depending on the goal, STI or LTI are suitable
- STI: emphasises urgency and increases flexibility
- LTI: goals that can only be achieved over a longer period of time
- Very important goals may also be in STI and LTI

Practical application:

→ At first more in STI, increasingly also in LTI or in both elements



# 3. How to implement ESG goals

## Weighting of the ESG targets

- No legal requirement
- Principle 6 DCGK requires predominance of long-term variable remuneration (LTI)

### Practical application:

- Higher weighting in the DAX than in the MDAX and SDAX
- Usually approx. 20-30 % of the STI or LTI



# 3. How to implement ESG goals

Weighting of the ESG objectives - Additive ratio or factor?

**ESG target as additive metric** = equivalent to financial performance criteria and additive linkage, e.g.

$$\text{STI} = (\text{fin. KPI 1} \times 50\%) + (\text{fin. KPI 2} \times 25\%) + (\text{ESG target} \times 25\%)$$

**Factor** = ESG target achievement corrected financial target achievement, e.g.

$$\text{STI} = [(\text{fin. KPI 1} \times 50\%) + (\text{fin. KPI 2} \times 50\%)] \times \text{ESG factor (0.8-1.2)}$$

With zero financial target achievement, ESG targets are irrelevant

## In Practise:

2020 Frequently factor in STI

Now more frequently an additive indicator



# 3. How to implement ESG goals

## Practice summary

- **ESG targets increasingly additive metric**
  - Increasing equality with financial performance criteria
- **Increasingly ESG targets in LTI or In STI and LTI**
  - Higher weighting of ESG objectives(G.6 DCGK)





# 4. Specification of ESG targets in the remuneration system

§87a para. 1 sentence 2 no. 4 AktG (legal) framework

"All financial and non-financial performance criteria for the granting of variable remuneration components, including

- a) an explanation of how these criteria contribute to the promotion of [the company's] business strategy and long-term development; and
- b) a description of the methods used to determine the achievement of the performance criteria."





# 4. Specification of ESG targets in the remuneration system

Practise

Disclosures in the remuneration system and annual target setting

*« The Supervisory Board shall determine the performance criteria for all variable remuneration components for the preceding financial year »*

Option 1: Specifying ESG goals in the remuneration system

Supervisory Board sets targets for ESG goals through the Supervisory Board's review for each financial year

Option 2: "Pool" of ESG targets / target categories

Supervisory Board sets ESG targets and target values for ESG targets through a review for each financial year (Common practise so far)



# 5. Conclusion Status Quo

Listed companies: **"whether"**

Germany: **rising expectations from investors**

USA: Countertrend

**Implementation** in variable remuneration; **decision-making scope** of the Supervisory Board

**Weighting** and differentiation of ESG goals **increases**

Identical requirements for disclosure of ESG targets and financial targets in **remuneration system** and **remuneration report**

Via **submission obligations** to the general meeting of shareholders increasing practical importance



# 6. Forecast

Non-listed companies - Art. 15 para. 3 EU  
Sustainability Directive /CS3D

## EU-Commission 23 February 2022

*"Member States **shall ensure** that companies take due account of **the fulfilment of the obligations** [to align the business model and strategy with the 1.5 degree target] **when determining variable remuneration**, where the variable remuneration is linked to the contribution of a director to the company's strategy and long-term interests and sustainability".*

## EU Parliament 1 June 2023

*„Member States shall ensure that **directors** are responsible for overseeing the obligations set out in this Article and that **companies with more than 1000 employees** on average have a relevant and effective policy in place to **ensure that pari of any variable remuneration for directors is linked to the company's transition plan** referred to in this Article. Such a policy shall be approved by the Annual General Meeting.“*

