

PUTTING SUSTAINABILITY ON THE PAYROLL

Linking directors' pay to companies' sustainability targets incentivises effective management of sustainability risks, impacts and opportunities

Executive summary

How can we incentivise directors to address sustainability impacts, risks and opportunities in a way that benefits companies, people and the planet? With the upcoming EU Corporate Sustainability Due Diligence Directive (CSDDD), it's important to consider how directors' remuneration can influence their decision-making and guide corporate behaviour.

In this briefing, we outline the importance of linking directors' variable remuneration to companies' sustainability objectives and make recommendations to achieve impactful change. With support from both financial and non-financial companies, we can drive positive change and create a fairer and more sustainable future for all.

Neglecting sustainability in directors' pay could harm companies' sustainability objectives

Variable remuneration is an integral part of directors' pay in many larger companies in the EU, effectively **influencing corporate behaviour**. Currently, directors' variable pay **is largely based on companies' financial results**, which often exclude longer-term sustainability considerations.

Excluding sustainability considerations from the remuneration packages of directors, though, fails to motivate them to effectively address sustainability risks and opportunities. This increases the risk of **undermining companies' economic resilience** and **neglecting their impacts on the environment and people**.

Knowing that aligning directors' pay with corporate sustainability targets is an effective means to set companies off on a path towards sustainability, **many larger companies already include sustainability criteria in variable remuneration**. However, **policy-level intervention is needed** to ensure such practices are applied by more companies on a systematic

basis, to create a level playing field and ensure the remuneration policies are effective.

Corporate Sustainability Due Diligence Directive offers a way

The **Corporate Sustainability Due Diligence Directive (CSDDD)** offers a **unique opportunity** to align a meaningful proportion of directors' variable pay with the pursuit of sustainability objectives. The European Commission's legislative proposal from February 2022 includes a provision for directors' variable remuneration. An effective and ambitious remuneration clause is **supported by many [real economy companies](#) and [responsible investor groups](#)**.

So far, **EU policy-makers have yet to capture the full potential of the CSDDD** to incentivise directors to take a leading role in companies' sustainability efforts. The Council's position is particularly worrisome, entirely deleting the already limited remuneration clause from the Commission's proposal.

Recommendations

For the CSDDD to be effective and impactful in practice:

- **A meaningful proportion of directors' variable remuneration should be linked to the company's sustainability objectives**, putting it on a more equal footing with financial objectives.
- The requirement to link a meaningful proportion of variable remuneration to sustainability performance should apply to **all companies in the scope of the CSDDD**.
- A company's sustainability performance should not only be based on a set of climate-related objectives but should encompass the **full range of sustainability matters**, such as biodiversity and human rights, ensuring alignment with corporate sustainability-linked goals.

1. Short-term incentives in directors' pay expose companies to negative sustainability risks and impacts

Markets alone [fail to safeguard](#) the long-term economic sustainability, and the interests of responsible companies and society at large, be it addressing climate and environmental issues or supporting human and labour rights. Currently, too many companies follow the corporate governance model focusing on maximising shareholders' value, which leads to prioritising short-term financial returns, while ignoring the longer-term sustainability issues, even if these affect companies' profits.

Directors' remuneration is often driven by maximising the profit in the short term. This is one of the reasons why companies might overlook sustainability risks and impacts. Directors' variable remuneration policies often largely refer to performance-based variable pay, which is [defined](#) predominantly by profit, share price, revenues and other indicators motivating directors to focus on short-term financial performance.

Variable remuneration is an integral part of the directors' salaries in many larger companies in the EU, making it a powerful tool to set impactful behavioural incentives in decision-making and showing its importance in steering the company. For instance, in larger publicly listed companies in [France](#) and [Germany](#), over two-thirds of directors' salaries are made up of performance-based benefits, which in most cases omit longer-term sustainability risks.

Excluding social and environmental considerations from directors' remuneration packages, however, [fails to effectively motivate](#) them to address sustainability risks and opportunities. Without directors' efforts to manage sustainability issues, companies may overlook important sustainability risks, struggle to adapt to market changes and are likely not to invest enough in their company's long-term viability, including within areas such as innovation and human capital. This can weaken the company's productivity, financial performance,

and resilience over time. In addition, shareholders may experience suboptimal investment performance and increasing sustainability risks to their portfolios.

Disregarding negative sustainability impacts when setting directors' remuneration also heightens the risk of management failing to identify and mitigate companies' negative impact on people and the environment. Neglecting sustainability matters increases the likelihood that companies contribute to environmental degradation, biodiversity loss, climate change and other environmental harm. Companies are also more likely to miss risks that they contribute to labour or human rights violations. Moreover, neglected impacts may mid-to-long-term turn into sustainability risks. For example, if a company's actions lead to climate change, this can eventually increase the vulnerability of the company's operations and assets to flooding, wildfires, and other risks.

While many companies already include sustainability criteria in variable remuneration, policy-level intervention is needed to ensure such practices are applied by more companies on a systematic basis. This will create a level playing field and assure the remuneration policies are effective. Studies have found that [66% of larger banks globally](#), and over 70% of the larger companies in [the US](#) and [Europe](#) have included sustainability criteria in remuneration policies. However, the same studies show that many companies do not set effective targets, have insufficient detail on the indicators, or do not include criteria for activities most relevant to their business models (e.g. financing for banks). Further, many oil and gas companies that have committed to cutting emissions from production and use of their products, simultaneously [reward executives for growing fossil fuel production](#). Policy-level action is needed for comparable and effective remuneration criteria and to ensure a level-playing field for all companies.

2. The Corporate Sustainability Due Diligence Directive can incentivise directors to address sustainability impacts & risks

The EU Corporate Sustainability Due Diligence Directive (CSDDD) offers the opportunity to require companies in the EU to link a proportion of directors' variable pay to companies' sustainability performance, thereby incentivising management to address sustainability impacts and risks and achieve sustainability targets.

Encouraging company leaders to prioritize sustainability can help companies become more efficient and attract more customers and investors who increasingly value sustainable practices. Linking a proportion of variable remuneration to sustainability targets would also help mitigate sustainability-related legal, financial and reputational risks, as the company proactively addresses sustainability issues in its operations and value chains.

Comprehensive guidance is already available to companies to ensure that their remuneration policies promote sustainable long-term value creation. This includes instructions from organisations such as the European Central Bank for [financial institutions](#) and the [Principles of Responsible Remuneration](#), which were recently launched at the World Economic Forum and apply to all sectors.

Both financial and non-financial companies and responsible investor groups support policy interventions that require companies to better integrate sustainability factors into directors' bonuses and pay. This is the case for leading [companies](#), such as ENGIE, Veolia, Generali and others, as well as [investor groups](#), such as the UN Principles for Responsible Investment, Eurosif, and the Investor Alliance for Human Rights. In France, the Business Convention for Climate, represented by 150 business leaders, has made [policy recommendations](#) that include conditioning executive's pay at least to climate matters, and ideally to all sustainability issues.

Mandating larger companies to make directors' pay dependent on the achievement of sustainability issues has also recently gathered considerable political support, most notably from French president Emmanuel Macron in his [presidential programme](#).

3. EU legislators have yet to capture the full potential of CSDDD

Although linking directors' remuneration to corporate-level sustainability objectives benefits both companies, people and the planet, **EU policy-makers have yet to capture the full potential of the CSDDD to incentivize directors to take a leading role in companies' sustainability efforts.**

In its legislative proposal for the CSDDD, which is currently being discussed in the European Parliament, the European Commission suggested that directors' bonuses should reflect the achievement of climate targets *only if* bonuses are already linked to the company's business strategy, long-term interests and sustainability. The **EU Member States in the Council** deleted the sustainability-linked remuneration clause entirely, putting at risk the Directive's goal for companies to effectively manage sustainability risks and impacts. The **views in the Parliament have been diverging**, with some committees deleting the remuneration obligation and others tightening it. For instance, the Committee on Environment, Public Health and Food Safety (ENVI) asks companies with more than 1000 employees to ensure that any remuneration for directors is linked to the company's climate transition plan. Despite adding a threshold, this would significantly improve the Commission's proposal, as the obligation would apply to all companies with remuneration policies in place.

So far, and at best, EU legislators have decided to link directors' remuneration to the achievement of climate targets and transition plans defined in CSDDD, not leveraging the Directive's potential to manage sustainability risks and impacts more comprehensively. Thus far, both co-legislators have yet to take the opportunity to extend remuneration policies to all sustainability matters, which would simply be consistent with the requirement for companies to

assess which sustainability issues are most relevant in their activities and/or value chains.

4. Key recommendations

To achieve a fundamental shift in companies' business strategies and ensure their long-term viability, company directors must be effectively incentivised to consider sustainability as an important factor in their decision-making.

Below are our key recommendations for the ongoing and upcoming discussions in the Parliament and inter-institutional negotiations, for the CSDDD to be effective and impactful:

- 1. To effectively incentivise company directors to prioritise sustainability, it is important to link a meaningful proportion of their variable remuneration to the company's sustainability targets.** This connection should be made explicit as an integral part of the Directive and should be tied to the directors' responsibility for conducting the company's due diligence obligations and implementing environmental transition plans.
- 2. The Directive should specify that the variable remuneration obligation applies to all companies in scope** by removing references to existing practices (e.g., obligation applying only to companies who are already linking sustainability targets to directors' pay) and any additional threshold.

- 3. The Directive must spell out that a meaningful proportion of variable remuneration should always be linked to climate and other materially relevant sustainability targets.** Such an approach should (i) make directors' variable pay reflect the need to put companies' financial and sustainability objectives on a more equal footing, (ii) integrate sustainability issues in remuneration policies in a meaningful manner, and (iii) limit greenwashing possibilities.
- 4. Sustainability criteria used for remuneration policies should encompass the full range of sustainability matters.** The current proposals are limited to climate objectives, whereas a coherent and effective approach requires greater articulation with general and specific obligations as spelt out in Articles 25 and 26. Sustainability-related remuneration policies should be based on a broader set of detailed and measurable criteria, which would provide more legal clarity to companies when pursuing sustainability targets.



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