INTEGRATING ESG ISSUES INTO EXECUTIVE PAY

A REVIEW OF GLOBAL UTILITY AND EXTRACTIVE COMPANIES
THE SIX PRINCIPLES

1. We will incorporate ESG issues into investment analysis and decision-making processes.

2. We will be active owners and incorporate ESG issues into our ownership policies and practices.

3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.

4. We will promote acceptance and implementation of the Principles within the investment industry.

5. We will work together to enhance our effectiveness in implementing the Principles.

6. We will each report on our activities and progress towards implementing the Principles.

CREDITS & ACKNOWLEDGEMENTS

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Executive pay remains at the forefront of corporate governance discussions for the investment community. Even post-financial crisis, high levels of executive pay, regardless of performance, continue to be the norm at many organisations, and are regularly reported in the media.

Linking environmental, social and governance (ESG) performance to pay can help hold executive management to account for the delivery of sustainable business goals. Executive pay should be aligned with performance and long-term strategy in order to protect and create value, but existing remuneration plans often do not promote sustainable value creation, which is in the interest of both companies and their investors. This lack of alignment is of concern for long-term investors, and presents opportunities for engagement to promote the consideration of ESG issues when setting pay.

This report highlights significant gaps in company practices and disclosure. Where ESG metrics are used, they often don’t reflect the issues that are identified as most material to performance, and many companies do not disclose the targets linked to those metrics. Developing transferable recommendations is challenging: companies argue that the complexity of business operations makes it difficult to identify either a set of ESG issues applicable to companies across the sector or a set of metrics sufficiently applicable across an entire company to be integrated into CEO pay.

These findings are a strong indication that the integration of ESG issues into executive pay is in its infancy, and further work on the issue is crucial.

We hope that you will join us in developing best practice on this key issue, so that together we can devise a more strategic and sustainable approach.
ABOUT THE PROJECT

Given the continuing intense scrutiny around executive pay, in 2012 the Principles for Responsible Investment (PRI) and Global Compact LEAD1 facilitated discussions between a diverse group of institutional investors2 and companies to explore the rationale, feasibility and effectiveness of including ESG factors in corporate executive pay plans to incentivise the delivery of long-term sustainable performance.

The project resulted in a guide for investors and companies on how to integrate ESG issues into executive pay.3 It outlined recommendations around three key areas of discussion: how to identify the appropriate ESG metrics for each company, how to link these metrics to executive pay packages and how to provide high-quality disclosure on such practices.

From 2013 the PRI worked closely with the investor group to explore the issue in more depth via further company dialogue and commissioned research in the utility and extractive sectors. These sectors are highly exposed to a range of ESG issues including companies’ license to operate, greenhouse gas (GHG) emissions and health and safety standards. Given such exposure, the integration of ESG metrics into executive pay was considered likely to be among the most robust, potentially shedding light on examples of good practice. In addition, based on an initial assessment, utility and extractive companies were perceived to be more advanced in their consideration of ESG issues in executive pay.

Discussions with a select number of companies4 and the bespoke research5 on related practices of the top extractives and utilities around the world form the basis for this report, which complements our 2012 guidance. It highlights key takeaways from the company dialogue, leading to additional points for engagement, and presents an overview of current practices in selecting ESG metrics and of levels of disclosure.

1 A leadership platform within the UN Global Compact
4 Legal and General Investment Management, Amalgamated Bank, First State Investments and APG met with seven companies identified as having leading practices, to test explore whether there are additional questions investors could raise in engagement meetings and to what extent recommendations could be made across the sector.
5 To complement these dialogues, a service provider mapped differences in the ESG-related pay practices of 84 extractive and utility companies in Australia, Europe and North America. More details are available in Appendix 1.
INTEGRATING ESG ISSUES INTO EXECUTIVE PAY

GUIDANCE FOR INVESTORS AND COMPANIES (2012 RECOMMENDATIONS)

1: IDENTIFYING APPROPRIATE ESG METRICS

Companies should adopt a clear process for identifying appropriate ESG metrics that relate to sustainable shareholder returns and company strategy. In order to do so:

1.1 ESG metrics should have a clear link to the optimisation of shareholder value and be aligned with the long-term business strategy.
1.2 Companies are encouraged to develop their own definition of sustainable value creation and use it to select appropriate ESG metrics.
1.3 Companies should consult with their shareholders in identifying ESG metrics and attempt to achieve a thorough stakeholder mandate to enhance internal and external support.
1.4 Companies should focus on ESG metrics that are generally forward looking, clear, attainable, replicable, comparable and time-bound.
1.5 When selecting key ESG metrics to be tied to compensation, companies should ensure balance, diversity and relevance.

2: LINKING ESG METRICS TO EXECUTIVE PAY

Companies should link appropriate ESG metrics to reward systems in a way that they form a meaningful component of the overall remuneration framework. In order to do so:

2.1 ESG targets should be integrated into an appropriate time horizon that is in line with business strategy.
2.2 ESG targets should be stringent and challenging to ensure incentivising outperformance.
2.3 Companies should select appropriate mechanisms and structures when creating incentive pay packages to ensure long-term shareholder value creation.
2.4 Incentive compensation should be subject to downward discretionary adjustments by the compensation committee to account for unusual events or unintended consequences as well as claw-back provisions.
2.5 In quantifying ESG metrics and measuring performance, the board may apply a clearly substantiated degree of discretion.

3: DISCLOSURE OF COMPANY PRACTICES

Companies should endeavour to disclose the rationale, method and challenges presented by the incorporation of ESG metrics into executive pay clearly and concisely. In order to do so:

3.1 There should be clear disclosure of the rationale in identifying ESG metrics linked to executive compensation and evidence of alignment with business strategy and shareholder value.
3.2 Disclosure of metrics and performance targets should be understandable and there should be clear and concise information regarding the structure and mechanisms used in linking ESG metrics to compensation.
3.3 Disclosure should provide sufficient information to allow investors to assess performance against ESG goals.
3.4 Disclosures of relevant ESG goals and their associated links to compensation should be integrated into official pay disclosures.
CHAPTER 1: NEW INSIGHTS FROM COMPANY DIALOGUE AND RESEARCH

The investor-company dialogue and research uncovered key additional insights to the recommendations of the 2012 guidance:

Companies should align the issues identified in sustainability reports with those integrated into pay packages. Any differences between the issues identified in sustainability reporting and those used in pay should be supported by a balanced and transparent rationale to assure investors that ESG factors that are likely to impact shareholder returns are well understood.

Among companies participating in the dialogue, most ESG issues integrated into pay had been identified as key in the company’s sustainability reporting, but companies generally do not seem to have a structured process for doing so, or provide a rationale. The research shows that the range of factors that companies integrate into pay remains narrow, especially when compared to the variety of issues highlighted in sustainability reports. It is common for a company to highlight specific material risks in the annual or sustainability report, such as regional licence to operate, but employ only a sole ESG metric in pay, such as safety, with no further explanation. None of the utilities companies in the research sample included climate change metrics such as greenhouse gas emissions in pay metrics.

Not providing such a rationale may undermine the company's commitment to sustainability and raise questions among stakeholders. In order to build trust, ensure shareholders’ understanding and gain investor support, companies should disclose, as clearly as possible, the link between material ESG performance and pay, or explain the absence of any such link.

Companies should provide more transparency over how targets for ESG performance are set, how performance is measured against the targets and how discretionary powers are used.

The last few years have demonstrated that ESG issues not managed correctly by the C-Suite can have devastating effects on a company’s reputation and financial performance (e.g. Volkswagen6 and GSK7).

During meetings, investors asked companies how ESG issues are incorporated into pay packages, and whether they could be more integrated into long-term incentive plans (LTIPs). Almost all companies in the dialogue emphasised a conviction that ESG performance is a key driver of financial performance, which is captured by financial metrics such as total shareholder return (TSR), which are in turn a key component of many pay plans. Some companies therefore reasoned that if pay-outs under LTIPs were based on TSR, with challenging targets for the next three to five years, overall ESG performance may be satisfactorily accounted for.

Despite the long-term nature of ESG issues such as employee satisfaction, safety, water quality, emissions and spill prevention, the research showed that metrics for these issues are applied to short-term incentives far more often than to long-term incentives, with no explanation as to why. The proportion of companies explicitly incorporating ESG issues into long-term pay in 2014 was just 15%.

Companies should explain how ESG issues could affect financial performance, and how this is reflected in long-term incentive plans. Companies that choose not to incorporate ESG metrics into executive pay plans, or only link them to short-term incentive schemes, should adequately explain how ESG issues are reflected in financial performance and the delivery of long-term strategy.

Most companies that participated in the dialogue have governance structures and processes to ensure board oversight of operational ESG issues and performance. This is important given the remuneration committee's responsibility to select appropriate ESG metrics and assess performance against a concrete set of targets.

However, while the research showed that a large majority of the companies disclosed ESG metrics related to pay, there was a significant lack of transparency on the specific targets set, and how performance is assessed against them: just over a quarter of companies in the sample had clear targets for ESG metrics.

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7 GSK to pay £297m fine for Chinese Bribes, FT.com, 19 September 2014 http://www.ft.com/cms/s/0/dea9811e-3fd5-11e4-936b-00144feabdc0.html#axzz3rOJdgU2o
For the majority of companies in the dialogue and the research sample, the board can exercise discretion to reduce or eradicate pay-outs based on poor ESG performance (determined by accidents or fatalities, for example). Discretion came across as a key tool companies already employ, and may use more, to assess performance against ESG issues. While companies agreed that discretion should always be accompanied by a meaningful rationale, the research showed that the companies in the sample did not provide detailed information on how discretion would be applied.

The research also showed that only a few companies have a more formalised approach towards ESG performance and pay, using structures such as gateways (through which earned incentives based on financial targets may only be paid when performance against ESG issues has been satisfactory) or bonus-malus structures (whereby failing to meet ESG targets, or exceeding them, will lead to a reduction or increase in any incentive award that might be generated by other achievements).

Companies should consider the role of their external remuneration consultants and ensure they have the necessary expertise to help select appropriate ESG issues and set metrics.

As is standard practice, most companies in the dialogue employed external remuneration consultants to help find the right financial metrics, to set targets and weighting and for peer benchmarking.

However, the majority of companies could not rely on their remuneration consultants to help select appropriate ESG issues and set metrics, other than to provide advice on weightings or examples of other companies’ practices.

This suggests a potential lack of expertise on ESG issues amongst remuneration consultants and raises questions about its impact on companies’ ability to identify and incorporate into executive pay the ESG metrics that could affect company performance in the short and long term.
CHAPTER 2: DATA FROM THE EXTRACTIVES AND UTILITIES SECTOR RESEARCH

The research analysis below summarises the practices of 84 extractive and utility companies included in major stock indices in North America, Europe, and Australia.

The research captured fifteen indicators related to ESG and pay practices for each company:

- Does the company link ESG issues to executive pay?
- What are the specific ESG factors referenced by the company?
- Are specific performance metrics defined relative to each factor?
- Are specific targets disclosed relative to disclosed performance metrics?
- Does the company incorporate ESG issues into short-term incentives?
- Does the company incorporate ESG issues into long-term incentives?
- What is the proportion of the incentive determined by ESG metrics?
- Is performance measured against targets pre-set at the beginning of the performance cycle to determine incentive pay-outs?
- Is performance considered retrospectively to determine incentive pay-outs?
- Are ESG factors incorporated into the measurement of performance relative to individual objectives?
- Are ESG factors incorporated into the measurement of performance relative to corporate objectives?
- Are ESG factors a precondition for a portion of the incentive award?
- Can ESG factors reduce awards otherwise earned?
- Overall, does the remuneration committee have discretion in determining pay-outs?
- Overall, can awards earned for performance in one period be clawed back in later periods due to restatements of performance metrics or other factors?

Every ESG-related performance factor mentioned by each company was captured and categorised into six groups: under four broad headings of Environmental, Social, Governance and Integrated Metrics (where ESG factors across multiple categories are tied together into one metric, usually a scorecard); and two more specific headings, Safety and Climate Change, given their particular pertinence for companies in the utility and extractive sectors.

The in-depth analysis of public filings for 84 companies revealed that:

- 83% of companies incorporated some type of ESG issue into compensation decisions.
- Among companies that integrated ESG factor into pay, 74% disclosed specific performance metrics by which ESG performance is measured.
- Despite the prevalence of disclosure on metrics, just 28% disclose a specific performance target.

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8 This analysis was based on public filings such as annual reports and proxy statements as of February 2014.
Of the 70 companies that incorporated ESG issues into executive pay plans:

- **84%** incorporated ESG factors into short-term compensation plans, rather than long-term incentives.

- **41%** of the companies that incorporate ESG factors into short-term executive plans do not disclose their weighting e.g. the specific proportion of the award that is based on meeting ESG targets. When weighting was disclosed, **ESG factors typically affected about 10% of the compensation package**.

- **51%** of companies measure performance against **pre-set ESG targets**, in order to determine pay-outs, while a **quarter of the sample looks at performance retrospectively**.

- **93%** of companies measure ESG performance at the **corporate level**, but just **16%** of extractive companies and **15%** of utility companies also incorporate them into the measurement of **individual performance**.

- **20%** of utility companies and only **6%** of extractive companies use ESG factors as a **precondition for awards**.

- **15%** of utility companies’ awards and **6%** of extractive companies’ awards that are otherwise earned can be **reduced based on ESG factors**.

- **24%** of companies allow for board discretion in determining remuneration awards, and **37%** have **clawback provisions**.

- **However, in both cases, companies did not provide detailed information** on how discretion would be applied or how it related specifically to ESG factors, or on how clawback provisions would be implemented and whether they might be triggered by anything other than misleading financial statements.
For the 70 companies across the two sectors that incorporate ESG factors, figure 2 summarises how they are integrated into pay, and which issues are most frequently employed.

Analysis of the data in figure 2 reveals the following patterns on metrics:

- Specific ESG performance metrics are disclosed in the vast majority of cases (92% for E, 86% for S and 83% for G/other), except for integrated ESG metrics, highlighting a lack of disclosure where integrated metrics are used.
- Environmental and safety metrics are each disclosed 90% or more of the time, possibly because these are seemingly more commonly quantifiable measures, and which are disclosed in other areas corporate reporting.
- Governance metrics are included at least 25% of the time in long-term awards, the highest percentage by far.

Figure 2: Usage of ESG Factors

<table>
<thead>
<tr>
<th></th>
<th>Any Metric</th>
<th>E</th>
<th>S</th>
<th>G/Other</th>
<th>Integrated ESG Metric</th>
<th>Safety</th>
<th>Climate</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Companies Using Factor</strong></td>
<td>70</td>
<td>24</td>
<td>21</td>
<td>12</td>
<td>26</td>
<td>52</td>
<td>3</td>
</tr>
<tr>
<td><strong>Metrics Disclosed</strong></td>
<td>74%</td>
<td>92%</td>
<td>86%</td>
<td>83%</td>
<td>37%</td>
<td>90%</td>
<td>100%</td>
</tr>
<tr>
<td><strong>Targets Disclosed</strong></td>
<td>28%</td>
<td>25%</td>
<td>15%</td>
<td>25%</td>
<td>13%</td>
<td>29%</td>
<td>67%</td>
</tr>
<tr>
<td><strong>Short-term</strong></td>
<td>94%</td>
<td>100%</td>
<td>95%</td>
<td>92%</td>
<td>97%</td>
<td>90%</td>
<td>100%</td>
</tr>
<tr>
<td><strong>Long-term</strong></td>
<td>16%</td>
<td>4%</td>
<td>14%</td>
<td>25%</td>
<td>10%</td>
<td>14%</td>
<td>0%</td>
</tr>
<tr>
<td><strong>Individual Targets</strong></td>
<td>16%</td>
<td>8%</td>
<td>10%</td>
<td>8%</td>
<td>17%</td>
<td>13%</td>
<td>33%</td>
</tr>
<tr>
<td><strong>Corporate Targets</strong></td>
<td>93%</td>
<td>96%</td>
<td>86%</td>
<td>92%</td>
<td>83%</td>
<td>96%</td>
<td>100%</td>
</tr>
<tr>
<td><strong>Pre-set Targets</strong></td>
<td>51%</td>
<td>46%</td>
<td>38%</td>
<td>33%</td>
<td>40%</td>
<td>52%</td>
<td>100%</td>
</tr>
<tr>
<td><strong>Retrospective</strong></td>
<td>24%</td>
<td>25%</td>
<td>14%</td>
<td>25%</td>
<td>20%</td>
<td>21%</td>
<td>0%</td>
</tr>
<tr>
<td><strong>ESG Precondition for Award</strong></td>
<td>10%</td>
<td>0%</td>
<td>10%</td>
<td>8%</td>
<td>10%</td>
<td>10%</td>
<td>0%</td>
</tr>
<tr>
<td><strong>ESG Can Reduce Award</strong></td>
<td>9%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>3%</td>
<td>10%</td>
<td>0%</td>
</tr>
</tbody>
</table>
SECTOR ANALYSIS

Figure 3 details the frequency with which each factor was used by extractive and utility companies. These percentages are based on 59 extractive and 25 utility companies.

Analysis of the data in Figure 3 reveals the following patterns on ESG topics by sector:

UTILITIES

The research indicates that 80% of the sample incorporated some ESG link in pay decisions. Of these companies, 65% disclosed metrics and 35% disclosed specific quantitative targets alongside them.

Safety is a key issue for the industry, therefore it is not surprising to see it featuring heavily in the data. While safety has a potential impact on physical, regulatory and reputational risk, this raises the question of whether there is an excessive focus on one key issue, as no other ESG factor was employed by more than half of companies reviewed. Social factors (excluding safety) are the second most integrated at 32%, but this does not seem adequate given the wide variety of social issues that could impact company performance, such as employee engagement and retention.

Governance and environmental metrics weigh heavily in the list of key ESG issues reported by companies; however, 24% of utility companies actually link governance-related metrics into executive pay and 16% integrate environmental factors. That 48% of utility companies use integrated metrics could explain this apparent mismatch as integrated metrics predominantly include health and safety and environmental issues.

No utility companies in the sample incorporated climate change metrics such as carbon emissions into executive pay, despite their own sustainability reporting as well as industry analysts and research experts referring to climate-related issues as a material risk.

Outliers or emerging best practice?

A few companies’ programmes stood out as having more sophisticated designs, for example, incorporating specific ESG hurdles before bonuses can be earned under other performance metrics. At the Australian utility SP Ausnet, long-term incentives cannot be earned when fatalities occur, and at the German utility RWE, ESG reporting and employee satisfaction metrics serve as the basis for a bonus-malus that can reduce awards earned in other ways.
**EXTRACTIVES**

The inclusion of ESG metrics in executive pay has become very common in extractive industries: 85% of the extractive companies in the sample linked pay to ESG issues and 78% of those disclosed the use of at least one ESG metric in determining executive pay. However, many extractive companies employed these metrics primarily as a qualitative factor in determining compensation and disclosed neither quantitative performance metrics nor specific targets against which performance was measured. Just 26% of the companies disclosed specific targets in determining compensation amounts.

As with utility companies, safety was the most commonly used ESG issue in pay, employed by 65% of extractive companies. This was followed by environmental issues at 33% and social issues at 22%, with only 10% of companies referencing governance issues.

Extractive companies better aligned the key ESG issues referenced by companies and industry experts with the ESG issues linked to pay. Safety is still a very important factor (66%) but the gap between it and environmental issues (34%) was narrower, and a further 29% use integrated metrics, which predominantly include health and safety and environmental issues.

However, despite the importance of social issues for the sector, and even for a company’s ability to carry out its operations (license to operate and political instability are crucial, especially in the regions where mining and drilling are often carried out), only 22% of the sample considered social factors when setting pay structures.

Climate change metrics such as carbon emissions are a significant concern for oil and gas companies but only three incorporated emissions-related metrics into performance pay.

**Utilities disclose fewer metrics, but those that do also include targets**

While the proportion of utility companies disclosing metrics was 13 percentage points less than at extractive companies, the proportion of companies disclosing targets was 9 percentage points higher than the extractive companies sample.
CONCLUSIONS AND NEXT STEPS

The company dialogue and research highlights that the integration of ESG issues into executive pay is in its infancy and there is considerable scope for investor engagement to improve practice and disclosure across all sectors.

Integration is hindered by the lack of a universally accepted standard of reference for boards, senior executives and remuneration consultants to assess relevant ESG risks and opportunities. Work underway by key organisations such as the Sustainability Accounting Standards Board (SASB) will provide more guidance in this area.

To successfully integrate ESG issues into executive pay, a holistic approach towards sustainable performance is needed to avoid creating incentives in isolation and avoid further complicating remuneration reports, which are often already lengthy and complex. To advance this work in the future, additional information is required:

- An in-depth analysis between companies’ public reporting of material issues and ESG factors integrated into pay;
- Better reporting by companies on ESG targets, performance against those targets and actual impact on pay.

Despite these challenges, there is room for investors to engage with companies to ensure that incentives are aligned with long-term strategic plans, and to ensure that this information is clearly disclosed. Engagement can help to ensure that senior management is held accountable for sustainable performance and sustained shareholder value.
# APPENDIX: DEFINITIONS AND GLOSSARY

<table>
<thead>
<tr>
<th>Topic</th>
<th>Definition used in company research and examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>Climate change</td>
<td>Specific reference to carbon emissions</td>
</tr>
<tr>
<td>Environmental</td>
<td>Other environmental-related factors such as pollution or water use</td>
</tr>
<tr>
<td>Safety</td>
<td>Worker safety</td>
</tr>
<tr>
<td>Social</td>
<td>Stakeholder concerns such as labour and community relations, product safety</td>
</tr>
<tr>
<td>Governance</td>
<td>Factors related to ethics and company governance</td>
</tr>
<tr>
<td>Integrated metrics</td>
<td>A number of ESG factors across multiple categories, i.e. qualitative performance factors or balanced scorecards</td>
</tr>
</tbody>
</table>

## Level of disclosure on the integration of ESG issues into executive pay

<table>
<thead>
<tr>
<th>Level</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Factor</td>
<td>Indicates that a general ESG-related consideration is included in executive pay decisions (e.g. safety)</td>
</tr>
<tr>
<td>Metric</td>
<td>Refers to the disclosure of a specific, typically numeric measure of ESG performance (e.g. lost time injury frequency)</td>
</tr>
<tr>
<td>Target</td>
<td>Refers to the disclosure of specific, pre-set targets against which ESG performance will be measured for determining pay (e.g. combined lost time injury frequency target below a certain number)</td>
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</tbody>
</table>
The Principles for Responsible Investment (PRI)

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance issues and to support signatories in integrating these issues into investment and ownership decisions.

The six Principles were developed by investors and are supported by the UN. They are voluntary and aspirational, offering a menu of possible actions for incorporating ESG issues into investment practices. In implementing the Principles, signatories contribute to developing a more sustainable global financial system.

More information: www.unpri.org

The PRI is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact.

United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a unique partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions that are signatories to the UNEP FI Statement on Sustainable Development, and a range of partner organisations, to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

More information: www.unepfi.org

UN Global Compact

Launched in 2000, the United Nations Global Compact is both a policy platform and practical framework for companies that are committed to sustainability and responsible business practices. As a multi-stakeholder leadership initiative, it seeks to align business operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to catalyse actions in support of broader UN goals. With 7,000 corporate signatories in 135 countries, it is the world’s largest voluntary corporate sustainability initiative.

More information: www.unglobalcompact.org