SUSTAINABILITY, ESG TARGETS AND THEIR INTEGRATION INTO MANAGEMENT BOARD REMUNERATION

BEST PRACTICE RECOMMENDATIONS AND THEIR CONTEXT

WHITE PAPER OF THE WORKING GROUP
GUIDELINES FOR SUSTAINABLE MANAGEMENT BOARD REMUNERATION SYSTEMS

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INTRODUCTION

The *working group guidelines for sustainable management board remuneration systems* advocates for simple management board remuneration aligned with the sustainable interests of the company. The committee is made up of prominent supervisory board chairmen of listed companies, institutional investors, academic representatives and corporate governance experts and it brings together the perspectives of corporate and consulting practice, academia and investors.[1]

Published for the first time in 2018, the *guidelines for sustainable management board remuneration systems* generated positive feedback in practice and were revised in December 2020 on the basis of the implementation of the Second European Shareholder Rights Directive by ARUG II[2] and the new version of the German Corporate Governance Code (GCGC)[3]. Already in the course of this revision, fundamental additions were announced for fall 2021. These would focus on two areas: the integration of environmental, social and governance (ESG) targets into management board remuneration and on transparency and comparability in the remuneration report.

From the midst of the working group, two sub-working groups were formed in order to drive forward the respective focus areas. This white paper adresses the focus area of the linkage of ESG targets into management board remuneration.[4]

Core of this document are best practice recommendations for linking ESG to management board remuneration, which are intended to provide companies with a guideline for successfully implementing this – not only for investors – important topic. For a better understanding of the context, the role of the institutional investors as a main driver of the integration of ESG targets into management board remuneration is outlined. This document also covers how ESG and management board remuneration are linked in today's practice, as well as a few concise company examples to illustrate best practices in implementation.

This white paper was prepared collaboratively by the members of the sub-working group and intensively discussed and adopted by the entire working group. This was presented to the public at a high profile conference on September 29, 2021.

* *Special thanks to Johannes Rieder, Senior Analyst at hkp/// group, for his cooperation on this white paper.*

[1] *An overview of the members of the working group is included at the end of this document. The guidelines for sustainable management board remuneration systems can be accessed using this link: http://www.guidelines-executivecompensation.de.*

[2] *Act on the implementation of the Second Shareholder Rights Directive (ARUG II) of December 12, 2019, Federal Legal Gazette (BGBl.) I 2019, p. 2637 - 2651.*

[3] *German Corporate Governance Code (in the version dated December 16, 2019).*

[4] *Members of the sub-working group "ESG and management board remuneration" included: Prof. Dr. Christina E. Bannier, Martin Jetter, Michael H. Kramarsch, Hendrik Schmidt and Dr. Antje Stobbe.*

BEST PRACTICE RECOMMENDATIONS FOR INTEGRATING ESG TARGETS INTO MANAGEMENT BOARD REMUNERATION

The best practice recommendations prepared in this white paper focus on linking ESG to management board remuneration in order to provide specific advice on how to integrate meaningful ESG targets into management board remuneration.

DESIGN

1. ESG TARGETS SHOULD BE COMPANY-SPECIFIC AND RELEVANT

To ensure a meaningful use of ESG targets[5] in management board remuneration, the selection of company-specific and strategy-relevant ESG targets is crucial. These should be derived in the sense of a holistic understanding of the company's interest.

Sector-specific ESG targets will emerge, which will then also enable comparability between companies in the same sector.

2. ESG TARGETS SHOULD BE SIGNIFICANTLY WEIGHTED

In order to create a clear incentive to pursue a holistic sustainability strategy, ESG targets should be weighted with at least 20% in the remuneration of the management board. This will create a clear incentive for the management board to take action towards achieving the respective ESG targets.

Such a significant integration is also in line with the proposal of the Sustainable Finance Committee of the German Federal government, which even advocates a 30% weighting in its final report.

3. ESG TARGETS SHOULD MAINLY HAVE A LONG-TERM FOCUS

The target achievement of ESG targets should mainly rely on the long-term remuneration component (LTI). Regardless of this, however – depending on the ESG target selected – integration into the short-term remuneration component (STI) can also be sensibly justified. This applies in particular to those ESG targets which by virtue of their nature make an impact in a shorter period of time, like employee-specific targets, customer satisfaction and input metrics within the framework of transformation processes.

4. ESG TARGETS SHOULD BE VERIFIABLY MEASURABLE

The ESG targets chosen should be mappable within the existing controlling and management systems, in order to ensure that their measurement is verifiable. This implies that the systems track ESG indicators that are relevant and material for implementing a comprehensive sustainability strategy.

ESG targets integrated into the management board remuneration should create focused incentives to implement such a holistic sustainability strategy. If necessary, companies should establish the necessary processes in order to implement appropriate controlling and management systems.

[5] *To the extent to which ESG targets are referenced within the best practice recommendations, this refers to those ESG targets relevant to management board remuneration.*

REPORTING/PRESENTATION[6]

5.
ESG TARGETS SHOULD BE AMBITIOUS AND BE TRANSPARENTLY DISCLOSED

The significance of sustainability and corresponding ESG targets should be emphasized by ambitious target setting. Corresponding disclosure of the target setting by the supervisory board and the definition of the target achievement curves in conjunction with significant weighting will create the necessary transparency how ESG targets are to be consistently pursued. At the same time, this allows target achievement to be accurately assessed, both internally and externally.

Services to be rendered by the management board as a matter of course or ensuring proper business operations – e.g. fighting corruption, protecting human rights, etc. – are not subject to separate incentive payments.

6.
ESG TARGETS SHOULD BE APPLIED AND REPORTED AS INTEGRATED AS POSSIBLE IN CORPORATE STEERING

Integrated reporting links (financial) economic indicators with the non-financial metrics of sustainability reporting and thus allows a holistic overview of the overall performance of a company. ESG targets that already exist and have been reported should be checked for their relevance and materiality (if appropriate, also externally) and used consistently.

DIALOG

7.
THE MATERIALITY OF THE TARGETS SHOULD BE DERIVED FROM THE BUSINESS MODEL

During the selection process for ESG targets, companies should engage with relevant stakeholders in a dialog and present which criteria have a material impact on their business model and how the specific ESG targets selected will contribute to the implementation of the corporate strategy, since only the improvement of material relevant targets will have a sustainably positive effect on corporate performance. The materiality matrix/analysis represents a central reference point for this. Further frameworks such as Materiality Map (SASB), IR Framework (IIRC), GRI Guidance or SDG contributions can be applied in a meaningful and appropriate manner. The IFRS Foundation is currently also developing applicable standards for sustainability reporting.

8.
RESPONSIBILITIES FOR ESG TARGETS WITHIN THE MANAGEMENT SHOULD BE CLEARLY ASSIGNED

Due to its strategic relevance, the pursuit of ESG targets represents one of the management board's traditional duties. Even though, the entire management board is responsible for the pursuit of ESG targets, ESG targets are to be assigned individually depending on the complexity of the organization and the responsibilities of the management board members.

The supervisory board supports the management board in designing and determining the company's strategy. Beyond that, it is also responsible for auditing the company's non-financial statement. In light of this, it must also deal with ESG aspects. The overall responsibility for this is with the supervisory board plenary, while ESG aspects are also to be handled within the relevant committees depending on their respective characteristics.

[6] *The white paper "Transparency of management board remuneration in the remuneration report" published by the working group at the same time as this document includes detailed information on the transparent reporting of (ESG) targets relevant in remuneration.*

CONTEXT: INSTITUTIONAL INVESTORS AS SHAREHOLDERS

Currently, the shareholder base of listed German companies is largely characterized by institutional investors. Institutional investors raise third-party funds, such as pension assets or through fund savings plans, and manage these funds professionally. The investors themselves are mostly international, predominant among these are investors from the US and the United Kingdom.

The major German institutional investors like Allianz Global Investors, Deka Investment, DWS and Union Investment jointly hold around 8.5% of DAX-listed companies, while international institutional investors collectively hold around 60% of the DAX.[7]

Institutional investors have to vote on agenda items at thousands of general meetings all over the world and engage in dialog with their investees. For illustration: The largest institutional investor BlackRock, who holds an average 10% stake in each DAX company, is invested in around 18,000 companies worldwide of which it has an annual exposure of around 10% in a more detailed exchange – the so-called engagement. BlackRock gives itself its own proxy voting guidelines, and it also maintains a dedicated large ESG team which provides a vote on all general meeting agendas with respect to ESG aspects. Many of the other institutional investors do not make such an effort. They decide as recommended by a proxy voting advisor in accordance with the proxy voting advisor‘s guideline. And this is how ISS and Glass Lewis, the two global players in the proxy voting oligopoly, got their influence.

Nowadays, funds raised by institutional investors are increasingly going toward passive investments. In other words, investors are replicating an index without making their own investment decisions. Influence on corporate strategy is therefore occurring through engagement with companies and by exercising voting rights, no longer mainly through investment decisions.

IN THE INVESTOR'S ALPHABET, G CAME BEFORE E AND S

There has been a fundamental shift in the focus of institutional investors in recent years. In the course of various corporate scandals – from the Philipp Holzmann bankruptcy and the accounting scandals at Enron and Worldcom to the cases of BP, Olympus and VW – the topic of "good governance" became more and more important. This shift has been accompanied by regulatory developments affecting jurisdiction and codes of corporate governance.

Through these scandals, many institutional investors became aware of the importance of the holistic topic of sustainability. This concept reflects the importance of a balance between different interests. As a simplified example: If BP, as the operator of the oil drilling rig Deepwater Horizon, had invested more in compliance, maintenance and servicing, their annual operating results would have been lower, but the oil drilling rig would likely still be generating profit in the future, and they could have avoided the extreme drop in share price.

Then as now, the topic of sustainability is discussed primarily in terms of environmental protection, thus returning to its origins: Sustainable management of a forest means cutting down only as many trees as needed to ensure a "harvest" every year. In the interest of future generations, we cannot destroy the foundations of life today. The associated pressure from society and regulatory frameworks has also contributed to the fact that investors have also adapted their engagement with companies to include climate targets. From the investor's perspective, this also primarily means smart risk management: Environmental protection means investment protection, as a leading representative puts it. In the absence of an active environmental management system, companies risk significant losses from sanctions, reputation risks and corresponding revenue losses.

[7] *Deutscher Investor Relations Verband/IHS Markit, Who owns the German DAX?, June 2021.*

In addition to G and E, investors have now discovered ESG's "S" dimension. The term Human Capital Management is generally used to capture this aspect, and investors are increasingly requiring the companies in their investment portfolio to communicate in greater detail in this regard.[8]

ENVIRONMENT, SOCIAL, GOVERNANCE – WILL SUSTAINABILITY OUTPERFORM TOTAL SHAREHOLDER RETURN?

Economist Milton Friedman constructed a school of thought in 1962 according to which a company's goal should be to maximize shareholder value. However, even then, he emphasized that this was built on the premise that the other interests (e.g. those of the employees, creditors, suppliers or even society and nature in the broader sense) were protected – either by means of a legal framework or through the active involvement of those stakeholders.

Apologists for the notion of pure shareholder value unfortunately have forgotten this critical premise. Almost 60 years later though, this concept is now being put into action. Generations Y and Z, both as employees and as customers, place significantly higher demands on companies in terms of their purpose, external image and the values represented by the company. More and more interest groups are calling upon companies to orient themselves toward sustainable corporate performance.

The dimensions "environmental", "social" and "governance," collectively referred to as "ESG", are considered as the central manifestation of sustainability. There is also an increasing demand for the "employee" dimension to be taken into account, so that the term "EESG" can now be found as well.[9] This illustrates how the interests of a company's workforce are also becoming a material component of sustainable corporate performance.

Various studies show that the alignment of corporate strategy with sustainable corporate performance considering relevant stakeholders can have a favorable influence on long-term corporate performance.[10] Important here is to ensure that sustainability is not viewed as an addendum to corporate strategy. Instead, it requires a holistic (re-)alignment of corporate strategy according to a holistic and integrated concept which takes all material ESG aspects into consideration.

If such transformation is successful, companies will benefit in many regards. First of all, they will become more attractive for the current and future generations of customers and employees. And for investors, too. On the one hand, investors are facing regulatory pressure to invest more heavily in companies operating sustainably. On the other hand, the changing views of private investors are also becoming more noticeable in this area: They don't just want to shop with sustainable companies, they also prefer sustainable investments.

As a consequence, companies with a holistic integrated sustainable strategy have an advantage on both the customer and the investor side, and they can benefit from this in terms of stronger demand for their products but also due to lower costs of capital and a higher enterprise value.

Thus, there is ultimately an interaction between a holistic sustainability profile and the total shareholder return: In the long run, only those companies successfully transforming to a corporate strategy aligned with sustainability will be successful and remain so. The transposition of a holistic and sustainable strategy forms the necessary basis for a positive development of the total shareholder return.

[8] *See hkp/// group, HCM Monitor DAX 2021.*

[9] *See, e.g., Katz/Mcintosh, Integrating ESG Into Corporate Culture: Not Elsewhere, but Everywhere, Harvard Law School Forum on Corporate Governance, 2021.*

[10] *See Khan/Serafaim/Yoon, Corporate Sustainability: First Evidence on Materiality, The Accounting Review, volume 91, no. 6, pp. 1697-1724.*

CONTEXT: INSTITUTIONAL INVESTORS AS SHAREHOLDERS

THE LEGISLATIVE FRAMEWORK TOWARDS A SUSTAINABLE ECONOMY

Global challenges like climate change are driving up the pressure on companies to operate more sustainably, and not only on the social side. Political initiatives on different levels are pushing for a more sustainable economy.

Agenda 2030, the United Nations resolution adopted in 2015, represents one decisive step in this direction. This agenda is based on a set of 17 goals called Sustainable Development Goals (SDG). These goals are intended to contribute on a global level to a development that is socially, economically and environmentally sustainable.

Several legislative measures are being taken in the EU to promote realization of a sustainable economy. The Sustainable Finance Disclosure Regulation[11] and the EU Taxonomy Regulation[12] are particularly worth mentioning in this context. While the former imposes disclosure requirements on the financial industry, the latter expands disclosure requirements for companies in the real economy.

The EU Taxonomy Regulation also introduces a classification system according to which economic activities can be assigned to different sustainability categories. According to the new EU Taxonomy Regulation, companies falling under the scope of the CSR Directive[13] must in the future disclose how and to what extent their activities are linked to environmentally sustainable economic activities.

Furthermore, the CSR Directive, which has been in place since 2014, is being revised in terms of content as well as scope of applicability.[14] To date, the directive has primarily affected large, capital market-oriented corporations with over 500 employees. Going forward, the reporting requirements are to be expanded to include smaller companies.

In addition, there is also a tightening of the content, in particular a clarification of which information companies should report in accordance with the principle of dual materiality. On the one hand, this includes information needed to understand how sustainability aspects affect companies, e.g. how climate change impacts a company's business model. On the other hand, the information needed to understand how companies affect people and the environment should also be published, e.g. how a company's business model impacts climate change.[15]

In addition to the global and European frameworks, efforts are also underway on a national level to contribute to implementing the UN's Agenda 2030 by means of the German Sustainability Strategy, which was last updated in March 2021.

The regulations and legislation aimed at reinforcing sustainability currently do little to address the topic of management board remuneration. According to Section 87 para 1 sent. 2 AktG, the remuneration structure is to be geared towards the sustainable and long-term development of the company. According to the explanatory memorandum, the term "sustainable development" should be understood to mean that the supervisory board shall also consider social and environmental aspects when designing the remuneration structure.[16]

[11] Regulation (EU) 2019/2088 of the European Parliament and of the Council dated November 27, 2019, on sustainability-related disclosures in the financial services sector.

[12] Regulation (EU) 2020/852 of the European Parliament and of the Council dated June 18, 2020, on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088.

[13] EU Directive 2014/95/EU of the European Parliament and of the Council dated October 22, 2014, amending EU Regulation 2013/34/EU regarding the disclosure of non-financial information and information related to diversity by certain large companies and groups.

[14] EU Commission, Proposal for a Directive of the European Parliament and of the Council, COM(2021) 189 final; Corporate Sustainability Reporting Directive (CSRD).

[15] EU Commission, Proposal for a Directive of the European Parliament and of the Council, COM(2021) 189 final, p. 16.

[16] Resolution recommendation and report of the Committee for Law and Consumer Protection, Bundestag document no. 19/15153, p. 55.

This requirement is repeated by the German Corporate Governance Code, however is not specified further. The Sustainable Finance Committee of the German Federal government adresses the subject area of how to integrate ESG into management board remuneration at a much higher level of detail. Its final report calls for the share of management board remuneration related to sustainability to be at least 30%, among other things. Furthermore, material "non-financial" performance criteria should be defined within the remuneration system.[17]

Even this brief overview shows that, overall, in addition to society's interests in the shift to a sustainable economy, regulatory efforts are also being made to significantly integrate sustainability into companies' strategic orientation.

THE ROLE OF INVESTORS

In the shift to a more sustainable economy, the capital market and, in particular, the long-term oriented institutional investors play a key role. However, they face two major challenges: On the one hand, private investors are increasingly looking for sustainable types of investments. On the other hand, as players in the European financial industry, they are also the focus of particular attention from legislators who aim to attain a more sustainable economy by regulating the flows of capital accordingly.

Besides developing a taxonomy, the EU Action Plan for Financing Sustainable Growth of 2018 addresses the promotion of sustainable corporate management.[18] Specifically, the importance of the investors is emphasized in this regard, and one subtopic here is the consideration of sustainable remuneration components.[19]

These goals were partially implemented into regulations by means of the Sustainable Finance Disclosure Regulation, which contents were again distinctly redefined through revisions under the EU Taxonomy Regulation. The disclosure requirements resulting thereof concern financial companies as such. For instance, the guidelines and procedures for considering sustainability risks must be disclosed, as well as a guideline and declaration on adverse effects on sustainability (principle adverse impact).

At the same time, the regulation creates extensive transparency requirements concerning the products offered. To create this transparency, the investment products offered by investors are divided into three categories according to their alignment with a sustainable economy. Depending on the classification, investors are required to publish different information for the products concerning their sustainability orientation. In addition to disclosure in the prospectus, some of this information also has to be published on the website and in the annual report.

In order to fulfill these increased transparency requirements and to be able to classify the products accordingly, investors need a corresponding data base from the respective companies in their portfolio, and they expect to see corporate strategies aligned with sustainability criteria. The companies undergo an ESG risk assessment in the process. Accordingly, investors formulate expectations for the companies in their portfolio to implement a corporate strategy aligned with sustainability and to consistently report ESG targets and indicators.

In doing so, investors are consequently requiring ESG targets being integrated into management board remuneration. The UN backed initiative Principles for Responsible Investment (PRI), a network of leading international investors, also recommends calling for portfolio companies to integrate ESG targets into management board remuneration.

[17] *Sustainable Finance Committee, Shifting the Trillions, p. 96.*
[18] *EU Commission Action Plan: Financing Sustainable Growth, COM (2018) 97.*
[19] *Bannier/Schmidt, Nachhaltigkeitselemente in den Vergütungsstrukturen der DAX-Unternehmen, ZfgK 2020, p. 992 (992).*

CONTEXT: INSTITUTIONAL INVESTORS AS SHAREHOLDERS

In this context, investors should also clearly state their expectations regarding the targets to be taken into consideration or the weighting of ESG targets in relation to the financial targets.[20]

The proxy voting guidelines of leading institutional investors and proxy voting advisory firms also include expectations for integrating ESG into management board remuneration. For instance, the four major German asset managers (Allianz Global Investors[21], Deka Investment[22], DWS[23] and Union Investment[24]) formulate these demands in their proxy voting guidelines for remuneration systems and in part also for remuneration reports[25]. Such expectations are also found in the Glass Lewis guidelines for Germany.[26]

The high relevance investors meanwhile attribute to the link of ESG targets and management board remuneration can also be seen in the fact that they are increasingly demanding that a substantial share of overall remuneration should be based on ESG targets.[27]

When it comes to selecting which ESG targets to use, the main aspect institutional investors are requiring is a close linkage to the corporate strategy. BlackRock, for instance, specifies that ESG targets are to be material and should reflect the company's strategic priorities.[28]

Relying on such material ESG targets further highlights investors' expectations that portfolio companies take a holistic approach to integrate ESG targets, and that management board remuneration should be used as one component of a holistic transformation.

Accordingly, the proxy voting guideline of DWS includes the expectation that companies establish a clear link between the ESG targets used and the remuneration system, and that this link is presented transparently.[29]

[20] *See https://www.unpri.org/executive-pay/esg-linked-pay-recommendations-for-investors/7864.article.*
[21] *See Allianz Global Investors, Global Corporate Governance Guidelines, p. 16.*
[22] *See Deka Investment, Principles of the Voting Policy for General Meetings 2021, p. 10.*
[23] *See DWS, Corporate Governance and Proxy Voting Policy 2021, pp. 6, 15, 16.*
[24] *See Union Investment, Proxy Voting Policy 2021, p. 4.*
[25] *See DWS, Corporate Governance and Proxy Voting Policy 2021, p. 17.*
[26] *See Glass Lewis, Guidelines Germany 2021, p. 14.*
[27] *Bannier/Schmidt, Nachhaltigkeitselemente in den Vergütungsstrukturen der DAX-Unternehmen, ZfgK 2020, p. 992 (994).*
[28] *See BlackRock, Corporate governance and proxy voting guidelines for European, Middle Eastern, and African securities 2021, p. 15.*
[29] *DWS, Corporate Governance and Proxy Voting Policy 2021, p. 6.*

EXCURSUS:

COMPLIANCE AS ONE COMPONENT OF GOVERNANCE WITHIN THE FRAMEWORK OF ESG TARGETS

One essential element of good corporate governance (see also Principle 5 of the German Corporate Governance Code) is the compliance aspect. As such, it falls within the governance area of the ESG target matrix.

Compliance generally describes compliance with legal requirements, but also following with the rules of conduct set by the respective company (e.g. code of conduct) which in some cases supplement the legal requirements (e.g. on corruption – accepting gifts) or which define additional obligations (e.g. governing conduct between employees).

As far as compliance with legal requirements is concerned, compliance is thus an outflow of the management board's duty of legality, which it must observe in managing the company. To the extent that compliance concerns observing guidelines that the company has defined for itself, the management board is generally bound by the rules of procedure for the management board issued by the management board itself or by the supervisory board and primarily by the corresponding provisions in the service agreements for the management board members, as these oblige them to comply with legal requirements as well as in-house guidelines.

COMPLIANCE CAN BE INTEGRATED INTO THE MANAGEMENT BOARD REMUNERATION IN SEVERAL WAYS:

- As a governance aspect within the ESG target matrix, compliance can be defined as a target within the variable remuneration. In this case, however, compliance is generally stipulated as a so-called knock-out criterion. Under this rule, compliance violations result in a full or partial forfeiture of the corresponding variable remuneration component. Thus, compliance is handled as a target to be met as a matter of course in the sense of a license to operate. Compliance should however not be able to contribute to exceeding ESG targets. It may be different as an exception when establishing a compliance organization is defined as a (project) target and the management board is not responsible for the current compliance organization not meeting the requirements.
- Irrespective of this, regulations are now being agreed in so-called malus/clawback clauses in management board service contracts which provide for the reduction or complete forfeiture or clawback of variable remuneration in the event of serious compliance violations.
- The supervisory board can be granted a discretionary right to change the variable remuneration by means of a modifier for violations below the threshold of severe violations.

Regardless of this, compliance violations attributable to a management board member can lead to that member's dismissal from the management board and to an extraordinary termination of the service agreement. In addition, the company may face claims for damages.

INTEGRATING ESG INTO MANAGEMENT BOARD REMUNERATION

Since the second European Shareholder Rights Directive was implemented, investors are able to articulate their expectations and requirements concerning the design of the remuneration system more explicitly at the general meetings. Section 120a para. 1 AktG, newly introduced by ARUG II, requires listed companies to submit the remuneration system, which Section 87a AktG requires them to prepare, to the general meeting for a consultative vote upon each significant change, but at least every four years. At the same time, the remuneration report to be prepared in accordance with Section 162 AktG will undergo an annual consultative vote no later than by the 2022 general meeting season.

Remuneration of a company's management board creates relevant incentives for implementing a corporate strategy. In view of the increasing pressure on companies to pursue an overarching corporate purpose geared to sustainability, they are increasingly being called upon to revise their corporate strategy holistically and to align it more clearly with a sustainable business or to readjust their existing sustainability strategies. As a consequence, ESG targets are increasingly reflected in management board remuneration systems.

CURRENT PRACTICE AT DAX COMPANIES

Since ARUG II took effect, management board remuneration must be harmonized with a remuneration system submitted to the general meeting. Investors often use the dialog regarding this framework, for instance, to point out a missing or inadequate integration of ESG in management board remuneration.

In recent years, a trend has emerged showing stronger integration of ESG targets in the management board remuneration of companies listed in the DAX.[30] Along with the mandatory submission of the remuneration system to the general meeting, numerous remuneration systems were even more aligned with investor expectations, whereby the integration of ESG targets into the variable remuneration was a key starting point. To date, ESG targets have mainly been integrated in the short-term variable remuneration, although more than half of the DAX companies now also provide for integration in the long-term variable remuneration.[31]

When it comes to the short-term variable remuneration, ESG targets are mainly applied collectively for the entire management board. It is common to define a catalog of different ESG targets from which the supervisory board selects the specific ESG targets for the respective financial year. Nearly all targets invariably include E targets, such as the reduction of CO_2 emissions or energy consumption, followed by S targets, which frequently address employee-specific concerns, and G targets, which are often based on compliance topics.

In this context, the selected ESG targets are less frequently integrated additively in the short-term variable remuneration as a stand-alone target. Rather, they are usually considered as part of a modifier. If modifiers are used, these usually range from 0.8 - 1.2, which has an effect of up to +/- 20% on the target achievement resulting from financial targets. As stand-alone and additively linked targets, ESG targets usually have a weighting of between 20% and 30% in the short-term variable remuneration.

If companies have integrated ESG targets into the long-term variable remuneration, these very predominantly also represent a collective target for the entire management board. Unlike in the short-term variable remuneration, integration generally occurs as a stand-alone target or as independent component within the long-term variable remuneration.

[30] *Bannier/Schmidt, Nachhaltigkeitselemente in den Vergütungsstrukturen der DAX-Unternehmen, ZfgK 2020, p. 992 (993).*
[31] *hkp/// group, Analyses DAX30 invitations to annual general meetings 2020 and 2021.*

Most DAX companies include more than one ESG target in their long-term variable remuneration. It is common to use an ESG component weighted at 20% to 30%, which reflects overall target achievement of several ESG targets. In contrast, inclusion by means of a modifier is much less common in long-term variable remuneration than in short-term variable remuneration.

Just as in the short-term variable remuneration, those ESG targets aimed at the E dimension of ESG are most common, followed by S targets. G targets are less frequently found in long-term variable remuneration.

Use of ESG targets addressing more than one dimension, such as the share of sustainable products in the product portfolio or the establishment of sustainable value chains, is becoming increasingly widespread.

While the majority of DAX companies is already far ahead in terms of integrating ESG into management board remuneration, other listed companies, particularly smaller ones outside of the main focus of institutional investors and lacking dedicated sustainability teams, have to catch up in terms of linking ESG to management board remuneration.

ESG TARGETS IN MANAGEMENT BOARD REMUNERATION SHOULD...

- be company-specific and relevant
- significantly weighted
- have mainly a long-term focus
- be verifiably measurable
- be ambitious and be transparently disclosed
- be applied and reported as integrated as possible in corporate steering
- be derived in their materiality based on the business model
- be assigned with clear responsibilities in the company management

MARKET PRACTICE OF INTEGRATING ESG INTO MANAGEMENT BOARD REMUNERATION

The following company examples portray specific expressions of integrating ESG into management board remuneration:

ADIDAS AG

SETTING A RELEVANT AND STRATEGY-DERIVED ESG TARGET IN LONG-TERM VARIABLE REMUNERATION

adidas AG defined the expansion of the area of sustainability as one of the key cornerstones of the corporate strategy. Derived from that, adidas AG integrated a clearly defined ESG target into the LTIP granted for the first time to the management board in 2021. With a weighting of 20% within the long-term variable remuneration, a significant increase in the share of sustainable articles in the product portfolio is incentivized as a strategic target. The final target and the time horizon foreseen for the ESG target and the strategic target coincide. Within the framework of the LTIP, an annual interim target can nevertheless be derived for the individual years of the performance period, in order to achieve a focused incentive and to specify the way to reach the long-term goal.

Another key element of the corporate strategy is to increase the credibility of the brand – increasing the proportion of sustainable products in the portfolio also promotes this strategic goal, as it reinforces the ambition to expand the area of sustainability. By adopting a strategic target into the long-term management board remuneration, adidas AG links corporate strategy and management board remuneration as closely as possible. The ESG target chosen addresses two cornerstones of the corporate strategy, thus achieving a particularly close link between management board remuneration and corporate strategy objectives towards a more sustainable alignment of the company‘s interests.

At the same time, the ESG target chosen addresses two ESG dimensions. On the one hand, expanding the business with sustainable articles targets the E dimension. On the other hand, by increasing credibility, which also falls back on expanding the portfolio of sustainable articles, the relationship to the company's customers (S dimension) is addressed.

MARKET PRACTICE OF INTEGRATING ESG INTO MANAGEMENT BOARD REMUNERATION

RWE AG

MEASURING ESG TARGETS IN BOTH SHORT- AND LONG-TERM VARIABLE REMUNERATION COMPONENT

ESG targets are integrated into both the short-term and the long-term variable remuneration in the current remuneration system for the management board of RWE AG.

In this context, the ESG targets are integrated in the short-term variable remuneration by means of a modifier (individual performance factor) with a range of 0.8 - 1.2. In addition to ESG targets, this modifier also reflects the individual performance of each management board member as well as the collective performance of the entire management board. The three factors of influence are each weighted with at least 25%. In order to ensure that target achievement is documented transparently, target achievement for the ESG targets is documented in the sustainability reporting.

As targets for the ESG component within the modifier, ESG targets with a short-term target horizon are used, the achievement of which is repeatedly relevant on an annual basis. These include aspects such as employee satisfaction or the adherence to compliance, environmental and social standards.

On the basis of the long-term strategic objective of climate neutrality, the management board remuneration system includes one ESG target from the E dimension, CO_2 intensity, in its long-term variable remuneration. Because of its strong strategic relevance, this target contributes one third to overall target achievement within long-term remuneration. In order to set the targets as adequately as possible, the target defined in the respective tranche of long-term variable remuneration is derived from medium-term planning. Target achievement is also measured using a transparent target achievement curve and is thus verifiable for the relevant stakeholders.

By integrating ESG targets into both the short-term and the long-term variable remuneration, incentives are created in the RWE AG management board remuneration system to address various ESG dimensions as well as ESG targets with different target horizons. Targets plausibly applicable within a short-term target horizon are integrated into the short-term variable remuneration. Meanwhile, one ESG target derived from a corporate strategy-related long-term target is defined in the long-term variable remuneration. The high significance of achieving this long-term target is underscored by its significant weighting within the long-term variable remuneration.

MARKET PRACTICE OF INTEGRATING ESG INTO MANAGEMENT BOARD REMUNERATION

DEUTSCHE BÖRSE AG

INTEGRATED RESPONSIBILITY FOR THE CONSIDERATION OF ESG IN THE COMMITTEES OF THE SUPERVISORY BOARD

In addition to the overall responsibility of the management board and any responsibility dedicated to an individual management board member, the supervisory board plays an important role in integrating ESG into management board remuneration. Deutsche Börse AG has decided to deal with ESG primarily in the strategy and sustainability committee due to its strategic importance, but also in the respective other committees in their respective forms.

As a result, for instance, it becomes necessary for the nomination committee – which also handles management board remuneration matters at Deutsche Börse AG – to define clearly measurable ESG targets harmonized with the corporate strategy for the variable remuneration along with transparent and ambitious target achievement curves.

Deutsche Börse AG's decision not to establish a separate ESG committee in the supervisory board but rather to integrate the topic into the strategy and sustainability committee, while also handling the ESG aspects in their respective form in the other committees, illustrates the strategic significance that ESG has for the company as a whole. In addition, handling those forms of ESG that are relevant to remuneration in the nomination committee ensures adequate and targeted treatment and will thus provide for clear assignment of responsibilities within the supervisory board.

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BACKGROUND INFORMATION

The *working group guidelines for sustainable management board remuneration systems* was established in 2018 by prominent supervisory board chairpersons, institutional investors, academic representatives and corporate governance experts. The objective was and still remains to compare investor requirements with corporate realities on the topic of management board remuneration and to contribute to a constructive dialog between companies and investors.

The guidelines for sustainable management board remuneration systems were first published in summer 2018. They contain key recommendations for designing a sustainable management board remuneration system in listed companies and provide these companies with orientation for aligning their remuneration system with investor expectations and the statutory and regulatory requirements.

An updated version of the guidelines for sustainable management board remuneration systems has been available since December 2020, a version which reflects revisions made due to the Second European Shareholder Rights Directive (ARUG II) as well as the new version of the German Corporate Governance Code.

Further details: www.guidelines-executivecompensation.de

THE FOLLOWING PERSONS ARE INVOLVED IN THE WORKING GROUP

Supervisory board members

Dr. Kurt Bock – BASF (Chairman), Fuchs Petrolub (Chairman), BMW (Member)

Dr. Werner Brandt – ProSiebenSat.1 (Chairman), RWE (Chairman), Siemens (Member)

Dr. John Feldmann – Hornbach Holding (Chairman), Hornbach Baumarkt (Deputy Chairman), Hornbach Management (Chairman)

Jürgen Fitschen – Vonovia (Chairman)

Martin Jetter – Deutsche Börse (Chairman)

Prof. Dr. Ulrich Lehner – Deutsche Telekom (Chairman), Porsche Automobil Holding (Member)

Prof. Dr. Norbert Winkeljohann – Bayer (Chairman), Deutsche Bank (Member), Sievert (Chairman)

Representatives of institutional investors

Dr. Vanda Rothacker – Analyst ESG Capital Markets & Stewardship, Union Investment

Nicolas Huber – Head of Corporate Governance, DWS Investment

Hendrik Schmidt, CESGA – Senior Research Analyst for Responsible Investment | Corporate Governance Center, DWS Investment

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Dr. Antje Stobbe – Head of Stewardship, Allianz Global Investors

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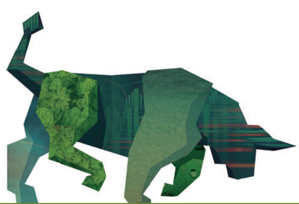

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