Institute for Sustainable Finance

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ANALYSIS

# Why ESG-Based Pay Often Falls Short — and How to Fix It

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Smith School of Business
Queen's University

# Contents

# ACKNOWLEDGMENTS

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# THE PROBLEM WITH PAYING FOR PURPOSE

When firms tie executive bonuses to environmental and social goals, they often assume that measurable targets will produce measurable impact. But poorly designed incentives can encourage "hitting the target while missing the point." Here's how boards can design ESG-based pay systems that actually work.

Marathon Petroleum was among the first companies to link executive pay to Environmental, Social and Governance (ESG) performance. But the devil is in the details. The company included the number of spill incidents, rather than their severity or volume, in its ESG metrics. As a result, Marathon met its ESG targets and paid out bonuses in 2018, even as a large diesel spill took place[1].

Marathon Petroleum's story illustrates a fundamental tension in corporate sustainability. As more firms link executive pay to environmental, social, and governance (ESG) goals, they assume measurable targets will drive meaningful change. The logic seems sound: tie pay to social or environmental outcomes, and leaders will work harder to achieve them. In practice, the link between incentives and impact is far less straightforward.

Energy companies may focus on easily achieved emissions reductions while neglecting harder, systematic decarbonization. Food companies may achieve "sustainable sourcing" certifications which only apply to a small proportion of their supply chain. When rewards depend on specific metrics, executives naturally direct resources toward hitting those numbers, even if it diverts attention from broader goals.

Roughly three-quarters of S&P 500 companies now link some portion of executive compensation to ESG goals. Firms like Apple, Unilever, McDonald's, PepsiCo, Shell, and Chipotle have joined this movement[2]. The intention is admirable, but results have been mixed. Some firms achieve genuine progress, whereas others merely reward executives for symbolic gestures or cosmetic accounting.

## THREE RULES FOR SUCCESSFUL ESG PAY SYSTEMS

Why do some ESG pay systems succeed while others fail? And how can boards design incentives that truly advance environmental and social outcomes without falling into the trap of compliance theatre?

### Rule 1: Don't pay for what the stock market already rewards

The first insight is counterintuitive: companies don't necessarily need ESG-based incentives, even when the board wants executives to advance ESG-related objectives.

Executives with equity-based pay are already rewarded for improving their company's reputation, resilience, and stakeholder relationships, all of which influence the stock price. Because many investors value sustainability, the stock market already rewards social and environmental performance to some degree. If a firm's share price reflects its ESG performance, paying executives based on stock returns alone may already encourage responsible behaviour.

The challenge for boards is to know when alignment is already achieved, and when it is not.

If a board's desired level of social investment aligns with what maximizes shareholder value, adding ESG pay metrics adds little.

For example, ExxonMobil historically emphasized shareholder returns from its fossil-fuel business more than aggressive climate transition goals. Accordingly, it ties more than 70 percent of executive pay to performance-based equity. Stock-based incentives already align with the company's objectives.

1 See "Despite spills and air pollution, fossil fuel companies award CEOs for environmental records," *Washington Post*, published Oct. 10, 2021.

2 See "ESG Performance Metrics in Executive Pay," *Harvard Law School Forum on Corporate Governance*, by Matteo Tonello published January 15, 2024.

This can also be true for companies whose environmental impact is largely positive, so that there is no clear tradeoff between financial and environmental performance. For a company such as Tesla, selling electric vehicles and energy products like solar panels is not only profitable but also generates environmental benefits, including reduced emissions and greater use of renewable energy. Perhaps not coincidentally, its executive compensation plans depend only on financial and operational performance targets.

However, when a board wants to go beyond what the stock market naturally rewards, for example by pursuing deeper decarbonization or stronger labour standards, explicit ESG incentives become essential. They supplement market signals and push executives toward outcomes that stock-based pay would underweight.

Unilever provides a clear example. Its Climate Transition Action Plan metrics are integrated into executive compensation, even though the corresponding initiatives may not necessarily maximize short-term stock performance. The company's board values long-term value creation and social impact. ESG pay serves as a governance tool to ensure management decisions align with those values.

The takeaway: before introducing ESG-linked bonuses, boards should ask a simple question: "Are we paying for something the stock market already rewards?" If the answer is yes, adding ESG metrics may simply double-count performance.

## Rule 2: Use multiple measures to prevent gaming

The second principle tackles the most common pitfall of ESG pay: gaming the incentive scheme.

Executives, like anyone else, respond to how their performance is measured. When incentives are based on narrow metrics such as carbon emissions or diversity percentages, leaders naturally focus on improving these narrowly-defined targets instead of outcomes that actually matter.

Because of their deep knowledge and understanding of their firm's operations, top executives are uniquely positioned to do so. They can tell which metrics are easy to improve even when the impact is minimal, and which ones are hard to improve even though they deliver real social value.

Energy firms might chase easy emission reductions while avoiding harder, structural changes. Food companies may trumpet "sustainable sourcing" certifications that apply only to a sliver of their supply chain. When a specific metric defines success, managers learn to manage this metric.

The best defence is to rely on a diversity of metrics. Using multiple, independent ESG indicators reduces opportunities for gaming. When metrics come from different data sources or methodologies, have a different scope, or consider different aspects of the same problem, they're harder to manipulate simultaneously.[3]

Marathon Petroleum offers a case in point. By linking ESG targets to the number of oil spills, it did not take into consideration the magnitude of these spills.

Consider Microsoft as a counterexample. The company's ESP strategy tracks progress across several dimensions, including carbon, water, waste, ecosystems, and customer sustainability. Each of these is evaluated through both internal audits and external frameworks such as the CDP (formerly the Carbon Disclosure Project) and the Task Force on Climate-related Financial Disclosures. Focusing on carbon alone, Microsoft's overarching goal is to become carbon negative. To measure progress, the company tracks multiple metrics rather than a single figure, covering direct and indirect emissions (Scopes 1 and 2), value chain emissions (Scope 3), carbon-free electricity expansion, and carbon removal initiatives. This diversity of metrics encourages leaders to pursue well-rounded progress rather than chase a single narrow indicator.

Still, more is not always better. Redundant or low-quality metrics can blur accountability and create noise. Boards should aim for a diverse but disciplined mix of measures. Each measure should be meaningful and grounded in credible data.

Inconsistency among ESG ratings is often criticized,[4] but diversity in methodologies can actually be a strength. When differences across ratings reflect distinct analytical approaches rather than poor quality, they make manipulation harder and incentive provision easier.

3 See "Executive compensation with environmental and social performance," by Pierre Chaigneau and Nicolas Sahuguet, published in 2025 in the *Review of Finance*.
4 See "Aggregate confusion: The divergence of ESG ratings," by Florian Berg, Julian F Kölbel, and Roberto Rigobon, published in 2022 in the *Review of Finance*.

### Rule 3: Match incentives to board priorities

The third rule may be the most important: ESG pay only works when it reflects genuine board priorities.

In firms where boards truly value environmental and social performance, even small ESG-linked pay components can drive meaningful change. In this case, ESG-based pay signals that the board is pursing objectives other than profit, and guides managerial effort accordingly.

On the contrary, when boards adopt ESG metrics mainly to satisfy stakeholders' expectations or deflect criticism, the reliance on these metrics becomes a simple compliance exercise at best and rent extraction at worst — when ESG incentives become another way for executives to inflate their pay.

Boards must therefore start with a discussion of intent. *Why introduce ESG pay in the first place?* Is the goal to enhance long-term shareholder value or to encourage social or environmental impact? The answer determines the right incentive design.

If the motive is purely financial, stock-based pay may suffice. But if the board seeks to achieve outcomes that stock markets currently under-reward, such as deeper emissions cuts or stronger community investment, then ESG incentives can be part of an optimal governance system.

This distinction reframes the broader debate around "doing well by doing good." Contrary to popular slogans and simplistic recipes, ESG pay is not designed to maximize the share price. It is a governance mechanism which can help achieve non-financial goals, depending on the board's willingness to trade off some financial upside in pursuit of social or environmental impact.

In summary, ESG pay must be grounded in clearly-defined objectives, not public relations. Without that foundation, even the best-designed systems will drift toward symbolism.

## FROM PRINCIPLES TO PRACTICE: FIVE STEPS FOR BETTER ESG PAY

No ESG-based incentive system will be perfect, but bear in mind that the best is the enemy of the good. Boards can strengthen their approach by following these steps:

1. **Clarify your purpose.**
   Decide whether ESG goals are meant to enhance shareholder value, reduce risk exposure, or achieve broader stakeholder outcomes. Each purpose implies a different pay structure.
2. **Diagnose stock market alignment.**
   Determine whether the stock market already rewards your desired ESG outcomes. If it does, stock-based pay may be sufficient; if not, add targeted ESG metrics.
3. **Select the right metrics.**
   Choose material areas that reflect strategic priorities. For each area, rely on several metrics which are independently verifiable and not overly correlated.
4. **Reward improvement, not attainment.**
   Use progressive targets or ranges to encourage continuous advancement rather than one-off threshold gaming.
5. **Communicate your rationale.**
   Be transparent about the rationale behind the inclusion of specific ESG measures and how they help encourage social or environmental impact.

When applied together, these steps transform ESG-linked compensation from a symbolic gesture into a credible mechanism for aligning corporate purpose, performance, and accountability.

## THE BOTTOM LINE

The rise of ESG-based pay reflects a genuine evolution in corporate governance: leaders are being held accountable for more than profits. But like any incentive system, it can be poorly designed.

Poorly structured ESG pay can produce the illusion of sustainability without substance: executives are rewarded for optics rather than outcomes. Well-designed systems, by contrast, channel managerial focus and corporate resources toward material outcomes.

There is no single recipe for success, but simple steps can improve the relevance and effectiveness of ESG-based incentives. Effective ESG incentives start with clarity of purpose, depend on diverse and transparent measures, and succeed only when backed by genuine commitment and monitoring. Firms that get this right will not just measure impact. They will create it.