Investigating factors fostering executive engagement in ESG initiatives: A comprehensive review to sustainable corporate governance

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ABSTRACT

Executive compensation and Environmental, Social, and Governance (ESG) goals are highly debated among scholars and practitioners as the world moves towards sustainable corporate practices. As companies nowadays have started recognising the importance of aligning financial incentives with sustainability. These companies are now integrating ESG considerations into executive compensation structures, known as ESG-based compensation. In addition to synthesizing existing literature on the effects of voluntary ESG practices on executive compensation, the research explores the role of psychological strategies in cultivating executive ESG engagement. The study offers insights into the relationship between ESG activities and top executive salaries, emphasizing the psychological components of executive behaviour. It underscores the financial and societal benefits of ESG integration, emphasizing the positive association between ESG performance and long-term financial success. While acknowledging that ESG-linked CEO remuneration may not directly boost financial performance, this exploration bridges the gap between ESG integration and executive engagement by explicitly examining the role of psychological strategies in fostering sustainable corporate governance.

Keywords: ESG Metrics, executive compensation, pay-performance, corporate governance, sustainability

INTRODUCTION

In today's rapidly evolving corporate landscape, including Environmental, Social, and Governance (ESG) principles into executive compensation schemes became an essential strategic move for ensuring sustainable corporate governance in the corporations. Upsurge in executive compensation is always been a debatable topic among experts and thus researchers and scholars are more working in this field related to the appropriate level of executive pay, the structure of compensation packages, and whether high pay is justified. These debates also consider the impact of executive compensation on corporate culture, ethics, and long-term sustainability and performance as corporates are moving towards green governance practices. Companies are changing how they pay their top executives thus creating a wage disparity with the employees. ESG-based compensation pays, also known as ESG-linked or ESG-incentivized compensation, refers to a compensation structure for executives and employees that ties financial rewards to a company's performance in meeting ESG goals and metrics. This approach is becoming increasingly popular as organizations aim to align their financial incentives with their sustainability and ethical objectives. ESG-based compensation can take various forms, including bonuses, stock options, or other financial rewards, which are linked to the achievement of specific ESG targets. For instance, an executive's bonus may be tied

to environmental goals such as reducing carbon emissions, social goals like promoting diversity and inclusion, and governance goals like improving board diversity and ethical practices.

As of a study conducted by Oxfam International (2023) revealed that the highest-ranking 150 executives in India earned an average of $1 million, marking a 2% uptick from the previous year. Shockingly, the study also indicated that these top executives in India managed to earn in just four hours what an ordinary worker earns in an entire year. Additionally, the report uncovered that these top CEOs saw a 9% increase in their pay in 2022, while workers globally experienced a 3% reduction in their earnings. Corporations are now using factors related to the environment, social issues, and good governance to decide how much money CEOs receive in order to justify it, by measuring productivity. This is somehow increasing the shareholder's confidence and bringing up the sustainable business environment. Integration of compensation program with sustainability can go long way.

This study aims to bridge the gap in the existing literature by providing a foundational understanding of the dynamics between executive compensation and firm performance, thereby setting the stage for future empirical research and contributing to the development of more effective ESG integration strategies in executive compensation. The integration of ESG principles into executive compensation promotes sustainable business practices and long-term corporate performance. This study addresses gaps in literature on effective implementation and impact by reviewing literature, examining theories, and analysing findings related to ESG metrics and executive compensation.

Review of Literature

India has implemented various reforms in the Companies Act of 2013 and SEBI guidelines to promote transparency, good governance, and ethical business practices. For instance, India has a unique legal provision that mandates companies to spend around 2% of their average profits from the previous three years on corporate social responsibility (CSR), as outlined in Section 135 of the Companies Act of 2013. This makes India the first country in the world to have such a law. Furthermore, the Ministry of Corporate Affairs, through the Amended Managerial Remuneration Rules of 2016, has made it mandatory for all listed companies to disclose the names of their top 10 highest-earning employees in their annual Board Report or to the Registrar of Companies when required. Some believe large executive pay is due to self-interested managers who extracts a large chunk of money as they are having the power to decide their own pay, while others see it as competitive compensation for top talent. A CEO is often considered to be highly successful, demonstrating exceptional leadership, skills, and qualities that serves as a link between corporate and shareholders wealth (Li, Li, & Minor , 2016).

A growing trend in the business world involves companies linking the compensation of their top executives to the achievement of goals related to environmental sustainability, social responsibility, and strong corporate governance. This reflects a broader recognition of the importance of these factors in today's corporate landscape and aims to align executive incentives with the company's commitment to ESG principles. This practice serves to incentivize CEOs and other leaders to prioritize not only financial

performance but also the broader impact of their organizations on the environment, society, and governance standards. Sometimes, ESG practices and financial goals of a company does not bring the result as expected and become competitive. This suggests that when a company prioritizes responsible and sustainable practices, it may face challenges in achieving its financial targets.

The study highlighting the central role of ESG in advancing corporate sustainability, environmental stewardship, and social responsibility, ESG principles not only influence the way businesses operate but also extend their influence to shape the broader societal impact. Challenges and solutions in implementing ESG goals within executive compensation are explored, casting light on the pragmatic approach required to overcome barriers and foster alignment with this transformative paradigm. Through meticulous analysis and reflection, this paper paints a comprehensive portrait of the profound implications of integrating ESG goals into executive compensation, emphasizing the catalytic potential it holds in shaping the corporate governance landscape of tomorrow. In a world where corporate responsibility has taken centre stage, this paper serves as a compass, guiding stakeholders towards a brighter and more sustainable future of corporate governance. Although study had also shown that current ESG Metrics using by the corporates are not bringing any benefit to the stakeholders rather these pay structures actually encourage CEOs to do their job well without caring about the other stakeholder's welfare (Bebchuk & Tallarita, 2022) and thus changes in ESG Metrics with alignment to the executive pay needs to be done. Recent developments in governance focus on how to use ESG indicators in executive compensation. The debate is shifting from whether to use ESG indicators to how to use them effectively and has gained attention in the corporate world. Studies show that many companies have made progress in using ESG indicators in compensation plans. Furthermore, the study underscores the evolving landscape of CEO remuneration, with a focus on board structure as a key factor. The need for competitive pay packages is emphasized to attract and retain top executive talent, aligning their interests with those of shareholders.

CEO Compensation and ESG Metrics

Studies showed that when companies disclose information about their environmental and governance practices, it creates a negative link between how well the company is doing and how much the CEO is paid, however when it comes to disclosing information about their social practices, it doesn't have the same effect but one also took into account other factors like the company's specific characteristics, the composition of the board of directors, and the CEO's attributes as controls for executive pay (Rath, Kurniasari, & Deo, 2020). Studies also showed that ESG practices not always boosts profits but corporates choose to follow as it somehow gains shareholders confidence. Companies aligning its own financial objectives with ESG Goals not necessarily achieves financial targets rather just increase in their ESG scores (Homroy, Mavruk, & Nguyen, 2023).

A recent study found that in companies using ESG (Environmental, Social, and Governance) metrics for executive pay, when they reduce their carbon emissions (CO_2), top executives tend to receive more variable pay. This suggests that ESG metrics are used to reward executives for their performance in ESG-

related areas. Many studies suggest that linking executive compensation to ESG performance can encourage responsible business practices, fostering long-term sustainability and risk management (Cohen, Kadach, Ormazabal, & Reichelstein, 2023).

Executive compensation

Empirically conducted study by (Frydman & Jenter, 2010) on US based public firms showed that CEO pay has increased significantly, especially when focusing on average pay instead of median pay. The pay growth has been higher in larger companies, resulting in a compensation premium for managing bigger firms. Additionally, CEOs have seen their pay grow more than other top executives, making the pay difference between CEOs and other top leaders even larger. The board's structure emerges as the primary determinant of CEO compensation, while company performance appears to have little influence. In other words, strong company performance does not necessarily translate to higher CEO pay, as indicated by the data analysed (Sikawa, Lu, & Latif, 2020). (Lemma, Mlilo, & Gwatidzo, 2020) found that higher board remuneration is associated with better financial performance in listed companies, while firm size and leverage have a negative impact on financial performance.

Studies indicate that CEO compensation and the incentives they receive can influence a company's actions, including its investment strategies, financial management, risk-taking, and information handling. This implies that linking CEO pay to performance is logical. However, definitively proving that CEO pay directly causes these actions is challenging due to the presence of numerous other contributing factors. Consequently, comprehending the precise impact of CEO compensation on a company's behaviour and value remains a major research challenge in the realm of executive pay.

Objective of the study

The study aims at exploring the existing literature in the field of formulation of executive compensation metrics in alignment with ESG principles. The study is conceptual in nature and review has been presented conducted with the secondary source which includes published articles and news articles. This paper explores the existing literature on the subject, shedding light on the potential benefits and challenges of incorporating ESG goals into executive pay.

Theories related to ESG and Executive Compensation

Optimal Contract Theory

The optimal contracting theory posits that executive compensation should be aligned with market competition and the demand for labour skills. This theory suggests that higher ESG (Environmental, Social, and Governance) performance justifies higher CEO pay because it reflects the executives' ability to meet market demands and deliver value to shareholders. According to this theory, aligning executive compensation with ESG performance incentivizes executives to prioritize sustainable practices that are beneficial for the long-term success of the company.

Rent Extraction Hypothesis

The rent extraction hypothesis argues that CEOs can use ESG engagement to extract private benefits, leading to excessive executive pay at the expense of shareholders. This theory implies that ESG activities may be utilized by executives to enhance their reputation and bargaining power, allowing them to secure higher compensation without necessarily contributing to shareholder value. In this context, ESG initiatives could be perceived as a means for CEOs to achieve personal gain rather than genuine corporate sustainability.

Conflict Resolution Hypothesis

The conflict resolution hypothesis, rooted in stakeholder theory, suggests that CEOs who prioritize stakeholder interests through ESG initiatives may receive lower pay to mitigate conflicts of interest among different stakeholder groups. This theory predicts a negative association between ESG performance and CEO compensation, as executives balancing multiple stakeholder demands might not be rewarded as highly as those focusing solely on financial performance. The hypothesis posits that reducing executive pay can help align the interests of stakeholders and minimize potential conflicts.

Stakeholder Influence Capacity

Stakeholder influence capacity theory emphasizes the role of stakeholder engagement in enhancing financial returns through corporate social responsibility (CSR) initiatives, which align closely with ESG goals. This theory suggests that firms with strong stakeholder relationships and high influence capacity can leverage their ESG activities to improve financial performance. By engaging stakeholders effectively, companies can enhance their reputation, build trust, and achieve better financial outcomes.

Table 1 discusses Theories with context to ESG metrics and Executive compensation

Theory/Hypothesis	Description	Key Points
Optimal Contract Theory	Suggests that executive compensation should be aligned with market competition and the demand for skills.	• Higher ESG performance justifies higher CEO pay. • Aligns executive compensation with ESG performance.
Rent Extraction Hypothesis	Argues that CEOs can use ESG engagement to extract private benefits, leading to excessive pay at shareholders' expense.	• ESG activities may enhance CEO's reputation and bargaining power. • May not contribute to shareholder value.
Conflict Resolution Hypothesis	Suggests that CEOs prioritizing stakeholder interests through ESG initiatives may receive lower pay.	• Negative association between ESG performance and CEO compensation. • Reducing executive pay can help align stakeholder interests.
Stakeholder Influence Capacity	Emphasizes stakeholder engagement in enhancing financial returns through CSR initiatives.	• Firms with strong stakeholder relationships can leverage ESG activities for better financial outcomes. • Enhances reputation, builds trust, and improves financial performance.

The above table provides a concise overview of how different theories interpret the relationship between ESG metrics and executive compensation.

Empirical studies on the relationship between ESG and executive compensation present mixed results. Some research supports the optimal contracting theory, showing a positive association between ESG performance and executive pay (Edmans, Gabaix, & Jenter, 2017), while other studies align with the rent-extraction hypothesis or find no significant relationship. Additionally, recent studies on financial institutions reveal that adopting environmental guidelines can increase executive compensation. The review also examines how firm attributes like size, leverage, and accounting performance interact with ESG to influence executive pay, providing a comprehensive understanding of the factors driving the ESG-compensation relationship. Studies conducted by (Milbourn, 2003) suggests that ESG engagement might be seen as a private benefit that enhances a CEO's reputation and bargaining power in pay negotiations, potentially wasting resources and detracting from shareholder value. Thus, a comprehensive approach is needed in order to design an appropriate pay design that can align with increase in value for the shareholders.

The study reveals that a higher Environmental, Social, and Governance (ESG) score is linked to higher executive compensation in Indian firms. This correlation is particularly strong in business-group affiliated companies and those operating in environmentally sensitive industries. The results underscore that firms with higher governance pillar scores tend to reward their executives more generously. Research argues that executive pay is fair and necessary to attract top talent, while others argue that executives can take advantage of their pay contracts. Our research suggests that adopting ESG standards can actually improve executive compensation by aligning it more with the interests of shareholders, which can make executive pay more efficient (Bebchuk & Fried, 2003). Studies showed that high executive pay is a result of market forces that incentivize firms to offer competitive compensation packages to attract and retain top executive talent. The authors emphasize that executive compensation should be viewed in a long-term context, where high pay is often necessary to motivate executives to make decisions that benefit the company over an extended period. (Frydman & Saks, 2010) showed a prominent rise in the compensation driven by a shift in the composition of executive pay, with stock options and incentive pay. This transformation challenges existing explanations for rising executive pay, suggesting factors like improved corporate governance, increased disclosure, and technological changes may have contributed to this evolution. However, arguments also suggest that the authors discuss the notion that executive compensation is a crucial tool for aligning the interests of executives with those of shareholders. They argue that high executive pays, when tied to performance, can help attract and retain the best talent, motivating executives to enhance the company's long-term value. However, implementing ESG practices in emerging economies like India presents unique challenges, including resource constraints and socioeconomic disparities. However, the growing emphasis on ESG integration in corporate governance offers opportunities for sustainable development and improved corporate citizenship, which can attract investment and enhance corporate reputation.

Table 2 summarises the study

S.no.	Study	Key Findings	Implications
1.	Bebchuk & Fried (2003)	High executive pay is seen as necessary to attract and retain top talent.	Aligning executive pay with shareholder interests can make compensation more efficient.
2.	Frydman & Jenter (2010)	CEO pay has increased significantly, particularly in larger companies.	Strong company performance does not necessarily translate to higher CEO pay.
3.	Eccles, Ioannou & Serafeim (2014)	Companies with robust ESG practices outperform peers financially.	"High Sustainability" companies perform better in the stock market and financially.
4.	Khan (2019)	Utilization of ESG metrics as key performance indicators (KPIs) for executives has surged.	Indicates the growing importance of ESG factors in executive compensation plans.
5.	Lemma, Mlilo & Gwatidzo (2020)	Higher board remuneration is associated with better financial performance in listed companies.	Highlights the importance of board structure in determining CEO compensation.
6.	Grewal & Serafeim (2020)	Strong correlation between ESG performance and long-term financial performance.	Emphasizes the financial benefits of incorporating ESG goals.
7.	Bebchuk & Tallarita (2022)	Current ESG metrics benefit top executives more than stakeholders.	Suggests the need for a comprehensive framework for assessing ESG metrics to address stakeholders' interests.
8.	Cohen, Kadach, Ormazabal & Reichelstein (2023)	ESG-linked executive compensation leads to positive ESG outcomes but not necessarily improved financial performance.	Suggests the need for balanced ESG and financial performance metrics.
9.	Homroy, Mavruk & Nguyen (2023)	ESG pay incentives do not always lead to increased firm value.	Indicates potential limitations of ESG metrics in driving financial performance.

Below is a conceptual model that illustrates the relationship between ESG metrics and executive compensation, incorporating the various theories and hypotheses discussed in the study.

- **Inputs**: ESG Metrics (Environmental, Social, Governance)
- **Theoretical Frameworks**: Optimal Contract Theory, Rent Extraction Hypothesis, Conflict Resolution Hypothesis, Stakeholder Influence Capacity
- **Outcomes**: Executive Compensation, Stakeholder Interests, Firm Performance, Long-term Sustainability

Numerous studies have highlighted the positive relationship between ESG factors and corporate financial performance. Research by (Eccles, Ioannou, & Serafeim, 2014) demonstrated that companies with robust ESG practices tend to outperform their peers in terms of financial metrics. Most importantly, it is found out that "High Sustainability" companies tend to do really well in the long run. They perform better in the stock market, which means their stock prices tend to go up over time, and they also do well when we look at their financial performance. So, not only are they doing good for the environment and society, but they are also making good business sense by being sustainable. This shows that being responsible and sustainable isn't just the right thing to do; it can be a smart and profitable business strategy as well. This finding was echoed by Grewal and Serafeim (2020), who found a strong correlation between ESG performance and long-term financial performance, thereby emphasizing the financial benefits of incorporating ESG goals. There are studies that shows when a company does well in its ESG performance as a whole, or in each of the individual categories (environment, social, and governance), it tends to be more profitable and affects its

overall value of the organisation (Aydoğmuş, Gülay, & Ergun, 2022). Findings revealed that combined ESG scores has significant positive result on firm value but the individual score of "Environment" score has no such significant impact on firm value whereas individual score of "Government" and "Social" have positive impact on a firm value.

The utilization of ESG metrics as key performance indicators (KPIs) for executives has surged. ESG factors are not only important from a sustainability perspective but can also have implications for investment decisions and financial performance (Khan, 2019), (J.P. Morgan., 2020). The more powerful a CEO is, the less likely the company is to be involved in Corporate Social Responsibility (CSR) activities, and if they do get involved, they tend to do it to a lesser extent (Li, Li, & Minor , 2016). However, there are studies which shows that ESG pay incentive not always leads to increase in firm value. (Cohen, Kadach, Ormazabal, & Reichelstein, 2023) concluded that ESG-linked executive compensation leads to positive ESG outcomes but does not necessarily improve financial performance. Similar results shown by (Homroy, Mavruk, & Nguyen, 2023).

The review of the existing literature concludes that a more holistic approach to executive compensation, integrating psychological strategies, is necessary to better align with ESG values and stakeholder interests. ESG metrics can serve as effective financial motivators, fostering sustainable corporate governance and encouraging executives to contribute to environmental and social well-being.

Conclusion

After going through extensive literatures, it can be concluded that the currently used ESG metrics for calculating executive compensation is benefiting more to the top executive managers rather stakeholders thus there are challenges for choosing a framework for the assessment of ESG based metrics that so that comprehensive needs of the other stakeholders can be addressed. A more rational approach to executive compensation is necessary, one that genuinely reflects a company's commitment to ESG values and the broader interests of stakeholders (Bebchuk & Tallarita, 2022). Stakeholder theory (Freeman & McVea, 2001) suggest companies become sustainable if it takes care of interest of all the stakeholder. Also, arguments (Bebchuk & Fried, 2006) suggest that executives have the control in setting their own pay which leads to upsurge in compensation and thus boards need to be more careful in their pay arrangements and make the compensation policy more transparent and fairer. This could involve refining metric choices, adopting longer-term perspectives, ensuring measurement accuracy and comparability, and involving stakeholders in the design and oversight of compensation frameworks. Studies also showed that ESG pay leads to increase in the variable pay of the executives as a reward so ESG metrics can act as a financial motivator in such a way that it can create a sustainable and responsible corporate governance and this may encourage them to prioritize and actively engage in actions that contribute to environmental and social well-being, aligning their financial interests with the company's broader sustainability goals.

The research also highlights the changing picture of CEO remuneration, with a focus on board structure as a key factor of CEO pay. It emphasises the need of competitive pay packages are required to

attract and retain top executive talent and align their interests with those of shareholders. In summary, the growing connection between executive compensation and ESG is a response to changing stakeholder expectations. It also signifies an increasing acknowledgment that ethical business practices play a vital role in achieving lasting success and sustainable growth. This study also revealed that the challenges are evident in linking ESG with executive compensation, encompassing the need to define suitable metrics, decide the significance of ESG elements, and secure the dependability and precision of the data utilized in assessments.

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Conflict of Interests

The authors declare no competing interests.

Author's Contributions

The idea generation and theoretical framework has been designed by Neha Aggarwal and based on the theoretical background results and discussions have been concluded by Dr. Kriti Bhaswar Singh.

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