

Our approach to engagement on incentives aligned with financial value creation

Investment Stewardship

BlackRock®

BlackRock Investment Stewardship (BIS) encourages companies to have sound corporate governance and business practices that support the durable, long-term financial value creation that our clients depend on to achieve their investment goals. As part of our fiduciary responsibilities as an asset manager to act in our clients' financial interests, we assess a range of risks and opportunities that can affect the long-term performance of the companies in which we invest on their behalf. We engage companies to understand their approach to the material drivers of risk and financial value in their business models, provide feedback and raise any concerns, as appropriate. We may signal continuing concerns through our voting, where clients have authorized us to vote on their behalf. In all cases, our voting is intended to advance the long-term financial interests of our clients as shareholders.¹

Executive compensation² is an important tool used by companies to drive long-term financial value creation by incentivizing and rewarding the successful delivery of strategic goals and financial outperformance against peers. However, when compensation policies are not well-structured, and when outcomes are misaligned with performance,³ companies may face business and/or reputational risks. To that end, appropriate and transparent compensation policies are a focus in many of BIS' engagements with companies we invest in on behalf of clients. In our view, it is important for companies to make clear in their disclosures the connection between compensation policies and outcomes and the financial interests of long-term shareholders.

Compensation that rewards long-term financial value creation

Compensation is a key tool used to attract, reward, and retain high caliber executives, and other senior employees, who are responsible for strategic decision-making and the durable, long-term growth of a company. A well-structured compensation policy serves to reward executives for accomplishments in the short-term, and to incentivize the delivery of long-term financial performance.⁴

Executive compensation typically consists of several components, including, but not limited to, annual base salary, short- and long-term incentive plans, and benefits plans.⁵ BIS looks to a company's board of directors – typically a relevant committee – to put in place a compensation policy that incentivizes and rewards executives against appropriate and stretching goals tied to relevant strategic metrics, especially those measuring operational and financial performance. BIS also looks for compensation plans to appropriately balance retention-oriented awards with service-oriented awards based on the context of the company and the circumstances of individual executives. Companies may establish guidelines to encourage executives to retain some of the shares received through these plans to further align the interests of management and shareholders over the long term.

In our experience, it serves long-term shareholders' financial interests when a meaningful portion of the compensation plan is tied to the long-term sustained performance of the company, as opposed to a singular vesting point tied to short-term increases in the stock price. The vesting schedules and holding periods associated with incentive plans should facilitate a focus on sustained long-term financial value creation. In our view, plans that have ongoing retentive and motivational components, and do not have points in discontinuity where the majority of outstanding awards vest, better align the interests of management and shareholders.

Disclosure that links pay and performance

We find it helpful when companies make clear in their disclosures the connection between compensation policies and outcomes, the performance of the company, and the financial interests of long-term shareholders. In most markets, companies are required to provide disclosures on executive compensation.

In addition to observing the relevant laws and regulations of their market of incorporation and listing, BIS encourages companies to consider enhancing their disclosure to provide shareholders and other key stakeholders with sufficient information to understand how compensation policies are structured and implemented.

In our view, compensation disclosure should explain how the components of a compensation policy work together to attract, retain, and motivate key executives. It is also helpful to investors' understanding when companies describe how compensation is set by the board or relevant committee, the details of the components of the compensation policy, any metrics used in performance-related incentives, and how the compensation policy and its outcomes are tied to strategy and long-term financial performance.

In addition, disclosures should clearly show how short- and long-term incentive plans have been designed to complement one another as an effective mechanism to deliver long-term financial value. A narrow or sole focus on short-term stock price or profit may be inconsistent with, or even detrimental to, long-term shareholder value creation. Moreover, any situation where there may be perceived or actual misalignment between executive pay and performance is best explained in detail and justified in terms of how it serves the financial interests of long-term shareholders.

Further, executive compensation outcomes are increasingly assessed in the context of the impacts a company has had on key stakeholders over the relevant period.⁶ In our view, it may be appropriate to take into consideration the interests of key stakeholders in compensation policies to recognize the collective nature of long-term financial value creation, and the extent to which each company's prospects for growth are tied to its ability to foster strong relationships with and support from those key stakeholders. To aid understanding, companies may consider disclosing how pay outcomes are consistent with a company's human capital management strategy and purpose.⁷ Such disclosure might discuss how companies have considered the interests of key stakeholders when reviewing and approving incentive plans and pay outcomes.

Executive compensation continues to garner significant attention. Poorly structured compensation policies – such as those that result in outsized potential or realized awards or with performance metrics not aligned with strategy – are likely to be even more closely scrutinized. This may carry potential reputational risks, particularly if pay outcomes are not aligned with financial performance or a company has negatively impacted key stakeholders, for example, through significant redundancies or product misselling.

Sustainability-related criteria in companies' incentive plans

BIS has observed that some companies continue to include sustainability-related criteria – such as those tied to specific environmental and social targets relevant to their business – as performance measures in their short- and long-term incentive plans. For example, meeting greenhouse gas (GHG) emissions reduction targets within a defined timeframe, among others.

BIS does not have a position on the use of sustainability-related performance criteria, but, in our view where companies choose to include them, they should be as rigorous as other financial or operational targets. When companies integrate sustainability-related criteria in their incentive plans, it is helpful if they clearly explain the connection between what is being measured and rewarded and the company's strategic priorities. Not doing so may leave companies vulnerable to reputational risks and/or undermine their efforts in addressing material sustainability risks and opportunities.

As companies navigate the transition to a low-carbon economy,⁸ we anticipate more will decide to include relevant GHG emissions reduction targets or low-carbon transition-related metrics in their incentive plans. Appropriate use of financial and other metrics aligned with long-term risk management may be increasingly important to some companies, given the materiality of these issues to their business models.

The role of the compensation committee

In most markets, a company's board of directors is responsible for putting in place a compensation structure that incentivizes and rewards executives appropriately. In our view, board compensation committees are in the best position to make compensation decisions and should maintain flexibility in administering compensation policies, given their knowledge of a company's strategic plans, the industry in which they operate, the appropriate performance measures and other factors that may be unique to the company.

When designing, reviewing, and approving executive compensation policies, board compensation committees – or board members responsible for setting executive compensation – should carefully consider the specific circumstances of the company, such as its risk profile, the environment in which it operates, and the individuals the board is trying to attract and incentivize.

We recognize that given these specific circumstances, compensation policies may sometimes differ from general market practice. Where compensation policies differ substantially from market practice (for example, an unconventional incentive plan design or decisions made in the context of transformational corporate events or turnaround situations) we look for companies to clearly explain in their disclosures how the approach taken by the compensation committee – or responsible board members – supports the company’s long-term performance and is aligned with shareholders’ financial interests. We recognize that compensation committees may, from time to time, determine it is necessary to use discretion to override the structure of an incentive plan or to make exceptional awards. In such situations, disclosures should address whether and why the committee used discretion, as well as factors taken into consideration in determining the appropriate compensation outcome. When evaluating potential windfall scenarios derived from market dislocations, midcycle adjustments, or company-specific events, compensation committees should also disclose how they determined whether executives benefited from a windfall or may do so in the immediate future.

Regarding non-executive directors’ compensation, the committee should determine compensation in a manner that is commensurate with the time and effort directors expended in fulfilling their professional responsibilities. These compensation arrangements should not risk compromising directors’ independence or aligning their interests too closely with those of company management, whom they oversee.

Additional considerations when assessing companies’ compensation practices

We understand that many companies assess their compensation policy and outcomes against those of peers to help ensure competitive compensation practices. However, we are concerned when the rationale for increases in total compensation is solely based on peer benchmarking rather than a rigorous measure of outperformance. We encourage companies to clearly explain how compensation outcomes have also rewarded outperformance against peer firms or against rigorous pre-set objectives.

As boards evaluate compensation policies, another factor they could consider is the level of shareholder support on relevant proposals at previous shareholder meetings, and other feedback received through engagement with shareholders and other key stakeholders. In our view, it is important for compensation committees to understand shareholders’ perspectives on compensation policy and outcomes. Committees should ultimately be focused on incentivizing executives to deliver long-term sustained performance aligned with shareholder value. In our experience, comprehensive and tailored disclosures that clearly explain the approach to compensation, rather than homogenous compensation policies, can be a key factor in gaining “Say on Pay” support.⁹

BIS is keen to understand how compensation committees balance the contractual obligations to and rewards for their executives, while preserving the link between pay and long-term performance and preventing outsized awards relative to originally established goals. Compensation committees should guard against contractual arrangements that would entitle executives to material compensation for early termination of their employment. Finally, certain retirement and deferred compensation arrangements can create reputational vulnerabilities for companies if they are not reasonable in light of market practice.

Our approach to engagement on executive compensation

When we analyze a company’s disclosures, BIS seeks to determine whether the board’s approach to executive compensation is rigorous, yet reasonable, in light of the company’s stated long-term corporate strategy and specific circumstances, as well as local market and policy developments. We use third party research, in addition to our own analysis of company disclosures, to evaluate existing and proposed compensation policies.

Where BIS finds apparent misalignment between executive pay and company performance, or has other concerns about a company’s compensation policies, we may engage to better understand the company’s approach. We prefer to engage with directors with the relevant oversight, most likely a member of the compensation committee, where we have concerns about or feedback on compensation policies or outcomes.

Lastly, we engage where we believe it would be productive to provide feedback or improve our understanding so we can make a more informed vote. We prefer to engage on proposed policies or plans when they are finalized, or near final, and there is a clear rationale as to why the approach to compensation is in shareholders' long-term financial interests. We don't believe it is appropriate for companies to engage with shareholders in the early stages of designing an incentive plan, primarily for the purpose of gauging support.

Endnotes

1. This commentary should be read in conjunction with BIS' [Global Principles](#) and [regional voting guidelines](#). Other materials on the BIS [website](#) might also provide useful context.
2. The term "compensation" is used as an equivalent to "remuneration" or "pay."
3. A compensation outcome generally relates to the payout of a performance-conditioned pay component, and reflects both the construction of the pay program as well as the performance of the company and executives against defined performance objectives.
4. In this commentary, "compensation policy" refers to the complete set of pay-related tools; "plan" refers to the specific short-term and long-term incentives schemes; and "practice(s)" refers to the processes behind determining how to deploy the compensation policy.
5. Deloitte Insights, "[Executive compensation: Plan, perform and pay](#)", 2023.
6. Key stakeholders are likely to include employees, business partners (such as suppliers and distributors), clients and consumers, government, and the communities in which companies operate, as well as investors. These are commonly the key parties within a company's value chain. As we explain in the BIS [Global Principles](#), it is for each company to determine their key stakeholders based on what is material to their business and long-term financial performance. To learn more, please also refer to the BIS commentary "[Our approach to engagement with companies on their human rights impacts](#)", January 2024.
7. For additional information, please see BIS' commentary, "[Our approach to engagement on human capital management](#)", January 2024.
8. See BlackRock Investment Stewardship's commentary, "[Climate-related risk and the low-carbon transition](#)", January 2024.
9. The terminology can vary across markets, but "Say on Pay" is the generic expression referring to the ability of shareholders to vote on a company's compensation policy, plan, and/or practices. For select markets in Europe, the Middle East, and Africa, this term may also refer to shareholders' ability to vote on the report companies publish on the implementation of its policies.

Want to know more?

blackrock.com/stewardship | contactstewardship@blackrock.com

This document is provided for information and educational purposes only. Investing involves risk, including the loss of principal.

Prepared by BlackRock, Inc.

©2024 BlackRock, Inc. All rights reserved. BLACKROCK is a trademark of BlackRock, Inc., or its subsidiaries in the United States and elsewhere. All other trademarks are those of their respective owners.

