Incentives aligned with value creation

Investment Stewardship

BlackRock

BlackRock Investment Stewardship (BIS) engages with companies to promote sound corporate governance and sustainable business practices that can help drive the long-term financial returns that enable our clients to meet their investing goals.

Executive compensation is a focus in many of BIS' engagements with executives and board directors.[1] Executive pay is an important tool to drive long-term value creation by incentivizing and rewarding the successful delivery of strategic goals and outperformance. It also carries business risks and reputational issues when compensation structures are not appropriate and outcomes are misaligned with performance. The following commentary describes BIS' expectations of and our approach to engagement on executive compensation as an incentive for long-term value creation.

Compensation that Rewards Long-term Value Creation

Executive compensation is a key tool used to attract, reward, and retain high caliber executives and senior employees who are responsible for strategic decision-making and the long-term sustainable growth of a company. An effectively structured pay package serves as an incentive for executives to drive long-term financial performance, within appropriate risk parameters, while building on short-term returns.

Executive compensation typically consists of several components, such as annual base salary, short- and long-term incentive plans, and benefits plans, among others.[2] BIS expects a company's board of directors to put in place a compensation structure that incentivizes and rewards executives against appropriate and rigorous goals and metrics. Outcomes should be aligned with shareholder interests – particularly the generation of sustainable long-term value. Executive stock ownership is also an important component of the pay structure to help create this alignment, with vested interest over time.

When designing, reviewing, and approving executive compensation programs, compensation committees should also carefully consider the specific circumstances of the company, its risk profile, the environment in which it operates, and the individuals the board is trying to incentivize.

Executive compensation is increasingly analyzed in the context of the experiences of a company's key stakeholders. To aid understanding, companies should consider disclosing how pay outcomes are consistent with a company's purpose and the pay structures within their workforce. Further, such disclosure might discuss how shareholder interests are juxtaposed alongside stakeholder considerations.

As we explain in our 2021 Global Principles, each company is responsible for determining its key stakeholders, based on what is material to its business.[3] BIS believes that companies who consider key stakeholder interests are more likely to produce long-term, sustainable growth with a multi-faceted view of their strategy, value add, and impact on customers, communities, and other constituents.

UN SDGs alignment

We believe that there is significant intersection between many of the topics that we discuss with companies and the Sustainable Development Goals (SDGs).

Sustainability-related metrics, such as those tied to specific environmental or social (E&S) targets are increasingly included as performance measures in companies' incentive plans. For example, companies may choose to tie executive pay to a number of safety metrics (S), such as accident rates or work days lost, or to an emissions reduction target within a defined timeframe (E).

A recent study by the Global Governance and Executive Compensation Group[4] showed that 67% of companies under analysis use environmental, social, and governance (ESG) measures.[5,6] Although sustainability performance metrics vary by region and industry, the study also found that COVID-19 has accelerated ESG incorporation in incentive plans. In addition, the study reports that "while most of these populate short-term incentive plans, ESG measures are now starting to appear in long-term incentives plans." As companies increasingly incorporate sustainability measures in their incentive plans, they should also be material and aligned with a company's long-term strategy. It is important that companies using sustainability performance metrics explain carefully the connection between what is being measured and rewarded alongside business goals and long-term performance. Failure to do so may leave companies vulnerable to reputational risks and undermine their sustainability efforts.

With rising investor and stakeholder expectations, executive compensation will likely continue to garner significant attention. In many markets, businesses and CEOs are increasingly counted upon to take a stand on social issues and step in when government fails to address them. At the same time, disproportionate executive pay – largely driven by outsized performance-based incentives in executive pay packages – is now widely scrutinized.[7]

The consideration for appropriately structured plans is of particular importance in the aftermath of the pandemic, which significantly impacted the average worker compensation, benefits, or ability to maintain employment. The appropriate use of capital and financial metrics aligned with long-term risk management and investment decisions are increasingly important as companies consider their strategy, investment in clean energy, and role in a transition to a net zero economy.[8] BIS believes it is in the best interests of companies and markets that the transition to a low-carbon economy is orderly and just. Careful consideration of human capital in this transition will allow for a more just and equitable shift.[9] In turn, companies that fail to properly disclose how their executive compensation structures align with their long-term strategy and purpose, including shareholder interests and key stakeholder considerations, may see their reputation damaged and their social license to operate impaired.

Expectations of Companies' Executive Compensation Practices

BIS believes that compensation committees are in the best position to make compensation decisions and should maintain flexibility in administering compensation programs, given their knowledge of a company's strategic plans, the industry in which it operates, the appropriate performance measures (including material sustainability-related metrics), and other factors which may be unique to the company.

In general, we expect a meaningful portion of executive pay to be tied to the long-term, sustained performance of the company, as opposed to short-term increases in the stock price. As a result, BIS will assess not only total shareholder returns, but also the company's overall strategy when evaluating long-term, sustainable performance.

We expect companies to be transparent about executive compensation structures and the outcomes sought. Companies should explicitly disclose how incentive plans reflect strategy and incorporate performance metrics, including sustainability-related goals, aligned with long-term shareholder value drivers. As such, we expect executive compensation plans to include short- and long-term components. Short-term plans could, for example, include material operational metrics aligned with one-year goals, and/or material non-financial metrics that are integral to the company's strategy. Long-term plans could, for example, have a balanced mix of absolute and relative three to five-year performance metrics that encourage prudent long-term investment and capital allocation decisions, with consideration to outcomes relative to the company's strategic plan and peers.

BIS believes that compensation structures should be company-specific and, as such, may differ from general market practice. However, where compensation practices differ substantially from market practice - e.g. in the event of unconventional incentive plan design or extraordinary decisions made in the context of transformational corporate events or turnaround situations - we expect clear disclosure explaining how the approach taken supports long-term sustainable performance and is aligned with shareholder interests. For a detailed review of our approach on compensation practices by market, please refer to BIS' regional proxy voting guidelines.

Companies should also disclose the timeframe for performance evaluation, i.e. the specific period over which shareholders should assess performance. For example, in a year when the company's market position has weakened and shareholders, employees, customers, and other stakeholders, have been negatively impacted, compensation committees should consider the reputational risk of making outsized payments to executives and justify difficult choices in the company's disclosures.

Where discretion is utilized, compensation committees should clearly explain how these decisions are either driving or creating long-term sustained performance aligned with shareholder interests. We expect especially rigorous disclosure and justification when mid-cycle adjustments are made. When evaluating potential windfall scenarios derived from market dislocations or company-specific events, compensation committees should disclose how they determined whether executives benefited from a windfall, or may do so in the immediate future. Disclosures should address whether and why the committee used its discretion, as well as factors taken into consideration in determining the appropriate compensation outcome. BIS is keen to understand how the compensation committee balanced the contractual obligations and rewards for their workforce and executives, while preserving the link with pay and performance, and preventing outsized awards relative to originally established goals.

Finally, as the compensation committee evaluates compensation policies, it should also consider how shareholders have voted on relevant proposals at previous annual meetings, and other feedback received through engagement. At the same time, the compensation committee should ultimately be focused on incentivizing executives to deliver long-term, sustained performance aligned with shareholder value and not necessarily on achieving a certain level of shareholder support for the pay proposal.

Our Approach to Engagement on Executive Compensation

When we analyze a company's disclosures, we seek to determine whether the board's approach to executive compensation is rigorous, yet reasonable, in light of its stated corporate strategy and performance metrics (including material sustainability-related metrics) that drive long-term value creation.

BIS takes a case-by-case approach and considers a company's specific circumstances, as well as local market and policy developments.[10] We acknowledge that executive pay proposals, such as Say-on-Pay,[11] and associated disclosures are not applicable to every jurisdiction.

Where BIS finds apparent misalignments between executive pay and company performance, or has concerns over a company's compensation structures, we may engage to better understand the company's approach to executive compensation. We believe that the board is responsible for establishing a compensation structure that incentivizes and rewards executives appropriately against rigorous goals and metrics, and that is clearly linked with corporate performance and shareholder interests, particularly the generation of sustainable long-term value. We prefer to engage with the relevant directors, most likely a member of the compensation committee. When executive compensation practices or structures are not aligned with our expectations, BIS may hold accountable members of the compensation committee, or equivalent, or vote against proposals to approve compensation.[12]

We engage where we believe it would be productive to provide feedback. We do not think it is appropriate or useful for companies to engage with shareholders primarily for the purpose of gauging support in advance of the annual general meeting, as voting is informed by disclosure. Rather, we believe it is more productive if companies have a final, or near final, proposed policy or plan to explain in the engagement, and an accompanying rationale as to why the approach is in shareholders' long-term economic interests.

Significant shifts, such as the COVID-19 pandemic, climate change, accelerating demographic and technological trends, and social issues, among others, will continue to expose companies to material business risks in the short- and long-term. As companies continue to respond and adapt to these and other interlinked ESG issues, we may engage with boards and executive management to understand how they have taken into consideration the impact of these developments on the business, shareholders, and key stakeholders in their compensation decisions.

Conclusion

Appropriately structured executive compensation packages help make a clear connection between the company's long-term strategy and shareholders' interests. Perceived or actual disproportionate pay, nonetheless, severs the link between compensation structures and long-term performance, and has the potential to create reputational risk. Companies should explain how their executive pay is closely tied to long-term, sustained value creation. Failure to do so will likely be met with opposition for executive pay programs from shareholders and key stakeholders through voting action and reduced support for the board and management team. When executive compensation practices or structures are not aligned with our expectations, BIS may hold accountable members of the compensation committee, or equivalent, or vote against proposals to approve compensation.

Endnotes

1. The term "compensation" is used as an equivalent to the words "remuneration" or "pay."
2. Deloitte Insights. "Executive compensation: Plan, perform and pay." 2021.
3. Key stakeholders are likely to include employees, business partners (such as suppliers and distributors), clients and consumers, government and regulators, and the communities in which they operate, as well as investors.
4. Guerdon Associates. Global Governance and Executive Compensation Group (GECN Group). "2021 and Beyond: Global Executive Incentive Trends. The Shift to Non-Financial Measures." 2021.
5. The GECN Group study on global executive trends collected global data on incentives from the most recent public disclosures for companies in the U.S. (S&P 100), Canada (SX 60), Continental Europe (CAC 40, DAX 30, SMI 20), the U.K (FTSE 100), Australia (ASX 100), and Singapore (STI 30).
6. The study also considered 'customer' and 'community' related measures as separate categories from ESG-related measures.
7. Yeung, P. "Why CEOs make so much money." BBC Worklife. 27 January 2021.
8. A net zero economy is one that emits no more carbon dioxide than it removes from the atmosphere by 2050, the scientifically-established threshold necessary to keep global warming well below 2ºC. See our commentary on our approach on "Climate Risk and the Transition to a Low-Carbon Economy" to learn more.
9. See our commentary on our approach on "Climate Risk and the Transition to a Low-Carbon Economy" to learn more. TCFD is focused on climate-risk reporting but, in our view, its four pillars - governance, strategy, risk management, and metrics and targets - are conceptually as applicable to all corporate reporting relating to environmental and social (E&S) risks and opportunities. The SASB standards provide the content, principally for the metrics pillar. We anticipate convergence in sustainability reporting frameworks and standards in the next few years but advocate for TCFD and SASB aligned reporting to meet investors' informational needs in the interim.
10. See previous footnote.
11. The terminology can vary depending on markets but Say-on-Pay is the generic expression referring to the ability of shareholders to vote on the compensation of executives.
12. For a detailed review of our approach to market-specific compensation practices, please refer to BIS' regional proxy voting guidelines.

Want to know more?

blackrock.com/stewardship | contactstewardship@blackrock.com

BlackRock.