Our approach to engagement on incentives aligned with financial value creation

BlackRock.

Investment Stewardship

At BlackRock, investment stewardship serves as a link between our clients and the companies they invest in and is one of the ways we fulfill our fiduciary responsibilities as an asset manager to our clients. We do this through engaging with companies to improve our understanding of their business models and material risks and opportunities. We also engage to inform our voting decisions for clients who authorize us to vote on their behalf. Our sole focus when conducting our stewardship program under our Benchmark Policies is to advance our clients' long-term financial interests.[1]

Executive compensation is an important tool used by companies to support long-term financial value creation. In our experience, well-structured compensation policies reward the successful delivery of strategic, operational, and/or financial goals, encourage an appropriate risk appetite, and align the interests of shareholders and executives through equity ownership.[2,3]

For these reasons, appropriate and transparent compensation policies are a focus in many of BlackRock Investment Stewardship's (BIS) engagements with companies our clients are invested in. To aid our understanding, we find it helpful when companies make clear in their disclosures the connection between compensation policies and outcomes and the financial interests of long-term shareholders.

Executive compensation that rewards long-term financial value creation

Executive 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 incentives, and benefits.[5] BIS looks to a company's board of directors – typically a specific 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 vesting points based on transitory 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 are more effective at aligning executives' and shareholders' interests when they are structured to motivate and reward participants periodically and over time, rather than when they have points in time where the majority of an award is achieved.

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.[6]

NM1224U-4112624-1/5

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

We find it helpful when compensation disclosure explains 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 target 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, we consider it best practice when disclosures clearly show how short- and long-term incentive plans have been designed to support corporate strategy and complement one another as a means to motivate appropriate risk taking and long-term financial value creation. A narrow focus on short-term stock price or profit may be inconsistent with, or even detrimental to, long-term shareholder value creation. Moreover, we look for any situation where there may be perceived or actual misalignment between executive pay and performance to be explained in detail, in particular how it serves the financial interests of long-term shareholders.

In some markets, executive compensation outcomes are increasingly assessed in the context of the impacts a company has had on key stakeholders over the relevant period.[7] In our view, it may be appropriate to take into consideration the interests of key stakeholders in compensation policies to recognize 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. Such disclosure might discuss how companies have considered the interests of key stakeholders when reviewing and approving incentive plans and pay outcomes. To aid investors in understanding their practices, companies may consider disclosing how pay outcomes are consistent with a company's human capital management strategy and purpose.[8]

Executive compensation can garner significant attention from shareholders, employees, policy makers, amongst others, in many jurisdictions. 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 mis-selling.

Sustainability-related criteria in companies' incentive plans

BIS has observed that some companies 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.

BIS does not have a position on whether companies should use sustainability-related performance criteria, but, where they are included, we look to companies to be as rigorous as they would be in setting other financial or operational targets. Where 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 to address material sustainability risks and opportunities and deliver long-term financial value for shareholders.

As companies navigate the transition to a low-carbon economy, some companies may decide that the use of climate-related performance metrics may be appropriate, if these issues are financially material to their business models. As such, we anticipate that more companies may decide to include these metrics, such as relevant GHG emission reduction targets, in their incentive plans.[9]

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 motivates and rewards executives appropriately. In our view, board compensation committees are in the best position to make compensation decisions. We recognize the need for these committees to 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 company's specific circumstances, 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 find it helpful when companies 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, we consider it best practice when compensation committees also disclose how they determined whether executives benefited from a windfall or may do so under the current compensation program.

Regarding non-executive directors' compensation, in our view, the committee should determine compensation in a manner that is commensurate with the time and effort directors are expected to expend 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 also considering rigorous measures of outperformance. We consider it best practice when companies 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 for 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 creation. In our experience, comprehensive and tailored disclosures that clearly explain the approach to compensation and that approach's support of business strategy, rather than simply adopting homogenous compensation policies, can be a key factor in gaining "Say on Pay" support.[10]

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 or accompanied by robust disclosure regarding how such arrangements are consistent with the company's business and executive compensation strategies.

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.

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 responsibilities, most likely a director serving on the compensation committee, where we have concerns about or feedback on compensation policies or outcomes.

NM1224U-4112624-3/5

Lastly, we engage where, in our view, 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 at a state where the company can articulate a clear rationale as to why the approach to compensation is in shareholders' long-term financial interests. In our view, it is inappropriate for companies to engage with shareholders in the early stages of designing an incentive plan, primarily for the purpose of gauging support.

Endnotes

1. BIS' Benchmark Policies, and the vote decisions made consistent with these policies, take a financial materiality-based approach and are focused solely on advancing clients' financial interests. BIS' Benchmark Policies – comprised of the BIS Global Principles, regional voting guidelines, and engagement priorities – provide clients, companies, and others, guidance on our position on common corporate governance matters. We take a globally consistent approach, while recognizing the unique markets and sectors in which companies operate. 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. Due, in part, to the Shareholders Rights Directive II (SRDII), we have recently found that a number of European companies have taken steps to address shareholder concerns around the structure and transparency of their remuneration policies. SRDII is a legally binding regulatory act which amended a previous EU Shareholder Rights Directive, introducing new transparency obligations and disclosure requirements to institutional investors and asset managers. Its goal is to enhance the flow of information across the institutional investment community and to promote common stewardship objectives between institutional investors and asset managers, while improving transparency of issuers, investors and intermediaries.
7. 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 2025.
8. For additional information, please see BIS' commentary, "Our approach to engagement on human capital management", January 2025.
9. For additional information, please see BIS' commentary, "Climate-related risk and the low-carbon transition", January 2025.
10. 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?

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NM1224U-4112624-5/5