Remuneration Governance in South Africa
2013 Survey results
‘Remuneration committees under pressure’
About this survey

This Ernst & Young’s survey Remuneration Governance in South Africa is the second since the new framework for remuneration governance was introduced. This survey aims to identify how today’s remuneration committees of Johannesburg Stock Exchange-listed (JSE-listed) companies are evolving in their response to this framework. Data from the 2012 survey is used for comparative purposes, helping to pinpoint trends and identify changes.

This report is intended to provide an overview of important trends in the key regulatory, governance and stakeholder issues affecting remuneration of employees in JSE-listed companies, as well as commentary on these trends. It is not intended to be used as a benchmarking tool.

Respondent profile

Members of remuneration committees of JSE-listed companies were invited to participate through an e-mailed questionnaire. We received responses from 51 remuneration committee members representing 54 remuneration committees of JSE-listed companies, across the following sectors:

<table>
<thead>
<tr>
<th>Sector</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrials</td>
<td>20%</td>
<td>27%</td>
</tr>
<tr>
<td>Financials</td>
<td>27%</td>
<td>18%</td>
</tr>
<tr>
<td>Basic materials</td>
<td>23%</td>
<td>16%</td>
</tr>
<tr>
<td>Consumer goods</td>
<td>7%</td>
<td>22%</td>
</tr>
<tr>
<td>AltX</td>
<td>10%</td>
<td>8%</td>
</tr>
<tr>
<td>Consumer services</td>
<td>10%</td>
<td>6%</td>
</tr>
<tr>
<td>Healthcare</td>
<td>3%</td>
<td>4%</td>
</tr>
<tr>
<td><strong>Responses received</strong></td>
<td><strong>30</strong></td>
<td><strong>51</strong></td>
</tr>
<tr>
<td><strong>Number of Remuneration Committees</strong></td>
<td><strong>33</strong></td>
<td><strong>54</strong></td>
</tr>
</tbody>
</table>

100% 100%
Foreword

This year, we were particularly interested in the following:

- Are institutional shareholders getting more involved in the remuneration affairs of the company? This was a new question.
- Are non-financial performance measures gaining traction?
- Is total shareholder return (TSR) still the primary metric used in long-term incentive schemes?
- What are the changing focus areas of remuneration committees?

Remuneration committees are increasing the number of meetings in the year, and the fees paid to remuneration committee members are approaching those paid to audit committee members. These are signs of a growing workload that is also becoming more technically complex in the face of higher expectations by a wide stakeholder group.

In light of the above, we trust that this report will provide guidance to remuneration committees.

Thank you also to all the survey participants for their support of this initiative.

Ray Harraway
Director, Performance & Reward
Ernst & Young

Under pressure

Until recently, executive remuneration had not been high on many investors' agendas. Now, however, many shareholders are contending that remuneration committees have not lived up to their responsibilities, nor have they been properly held to account. In Europe, North America and Asia, these committees are under pressure from shareholders (often via proxy advisory firms) who are demanding to be more actively involved as part of the “say on pay” trend.

Source: Ernst & Young, Reporting, 5 March 2013.
Background

The Companies Act, 2008 and the King Report on Governance for South Africa 2009 (King III) give shareholders a greater voice in the remuneration policies and practices of a company. King III recommends a non-binding shareholder vote on the remuneration policy. It is intended to give feedback to the directors on policy items related to remuneration, and not directly on pay levels. The Companies Act sets out disclosure and approval requirements affecting directors’ remuneration.

It seems however that some of the recent negative shareholder non-binding votes at South African annual general meetings (AGMs) are to express dissatisfaction with pay levels, as well as the lack of disclosure of performance targets.

This emerging practice begs the following questions:

- What should the remuneration policy contain, bearing in mind that a policy would normally not contain the level of pay (the ‘how much’) of pay, but rather the ‘how’ of pay?
- Are changes to our framework needed, along similar lines to the United Kingdom (see below)? Should shareholders not give clearer direction relating to specific items of remuneration policy that are causing dissatisfaction?
- Is our remuneration governance framework being applied as intended?

The UK Government has approved reforms of the regulations relating to the pay of directors of listed companies. These changes will come into effect in 2014:

- The annual directors’ remuneration report will be split into a forward-looking policy report and a backward-looking implementation report.
- A binding shareholder vote on the directors’ remuneration policy to take place at least every three years.
- Any remuneration that is inconsistent with the latest approved policy will be voided, unless separately approved by shareholders.

“We have seen an unprecedented focus on executive remuneration in the UK from regulatory authorities, legislators, shareholders and the media.”
Source: Ernst & Young, Changing landscape of executive remuneration, 2012.
Survey highlights
Survey highlights

Three highlights that are consistent with the 2012 survey:

- The non-binding shareholder vote prompts changes to pay programmes.
- Shareholders (institutional investors in particular) have become more active in the remuneration affairs of the organisation.
- Remuneration committees will be placing more focus on linking pay to performance over the next 12 months.

Two highlights that differ from the 2012 survey:

- This year there is a strong vote of confidence in the ability of the remuneration governance framework to reduce problematic pay practices.
- The use of non-financial and total shareholder return performance metrics in incentive schemes has dropped compared to 2012.

In summary, South African governance of executive remuneration is impacted by two main trends:

- Shareholder activity is increasing.
- There is a strong focus by remuneration committees on aligning pay with performance, with renewed efforts to understand and establish performance metrics. These trends are broadly in line with global developments in remuneration governance.

Company-shareholder engagement is reshaping the governance landscape. Shareholders are providing more input into corporate governance decisions and gaining more access to management teams and directors. They’re using this engagement and proxy disclosures to evaluate the company’s governance practices and board effectiveness.

Source: Ernst & Young, “Preparing for Shareholder engagement”, BoardMatters Quarterly, April 2013.
A. The non-binding shareholder vote

Did the vote bring about changes to pay programmes?

In its second year, the vote has, once again, had an impact. In total, 20% (22% in 2012) of respondents made changes to their pay programmes in response to the non-binding shareholder vote.

Ten percent of respondents stated that the vote prompted changes to their pay programmes before the AGM, and a further 10% said that the vote prompted changes at or after the AGM.

What level of votes against the remuneration policy would you consider to be a ‘failed vote’?

There is no clear consensus. Thirty-three percent of respondents believe that a “failed vote” is where more than 30% of shareholders vote against the policy, while 29% believe this cut-off point should be more than 50%.

33% felt that a failed vote is more than 30% of votes against the policy.

King III recommends a minimum of 50% of shareholders’ vote in approval of the remuneration policy. Is a simple majority vote adequate support? Is the company prepared to face negative media or reputational damage in the event that a substantial minority (say 30%) votes against the policy?
Our point of view is that a vote of less than 70% in support of the policy is a warning sign that the organisation runs the risk of a vote failure in the next year if the pay concerns are ignored. Practically, as long as the vote is non-binding, the answer to the question of what is an appropriate level of support will depend on the perspective of the board and the make-up of its shareholders. Regardless, the board will need to formulate an approach to these questions:

- When should it react to shareholder dissent?
- When should it be proactive in engaging on matters causing such dissent?

Proxy advisors in the United States appear to be promoting a minimum support of 70% to 80%. In Australia, shareholders can oust a company’s entire board if there are two successive annual votes of at least 25% against the remuneration report.

B. Shareholder engagement: A new era of shareholder involvement?

Do you agree with the following statements?

- Shareholders, generally, have become more active in the remuneration affairs of the organisation.
- Institutional shareholders, specifically, have become more active in the remuneration affairs of the organisation.

This year 84% (83% in 2012) felt that their shareholders have become more active in the remuneration affairs of the organisation. Eighty-two percent believe that institutional shareholders, specifically, have become more active in the remuneration affairs of the organisation.

82% believe that institutional shareholders, specifically, have become more active in the remuneration affairs of the organisation

CRISA may well have been a major contributor to this rising level of shareholder activity. As this trend evolves, attention will inevitably fall on the quality of dialogue between management and shareholder. Based on our experience, not all institutional investors are transparent on their voting decisions, nor are they always transparent on the reasons behind their decisions.

This suggests that shareholders, and their advisors, need to reassess their conduct, particularly in the light of clear direction from CRISA and other codes. Disclosure of voting is a key aspect of good corporate governance. One of the five CRISA principles requires institutional investors to be transparent about their investment and corporate governance policies. “Activity” without “engagement” is neither good governance nor responsible ownership.

This year 19% (29% in 2012) said that they had made changes to their pay programmes as a consequence of engagement with shareholders. Despite this decline, it must be recognised that shareholders continue to exert a high level of influence. Forty eight percent (54% in 2012) indicated that they proactively engaged directly with their larger investors.

Engagement between management and shareholder will require new skills for many, as well as time commitment (not just at AGM time) and resources. Sensitivities around sharing targets, forecasts and other information likely to affect price will need to be managed with care.

The 2012 survey did not include a question on institutional investors.
Did you take steps to proactively engage with your shareholders before the AGM?

Did your Remco take steps to proactively engage directly with your larger investors before the AGM?  

Did your Remco take steps to proactively engage indirectly with all shareholders before the AGM?  

The Remuneration Committee and the Chair in particular, should be able to answer the following questions:

- Is there a process in place to deal with requests from shareholders for dialogue and are these requests shared with the board?
- Does the board understand the governance views of the company’s largest shareholders?
- Has the company identified shareholders beyond the top 10 or 15 that are active filers of shareholder proposals?
- Has the board identified directors who could speak with investors?


"The chair should have ... experience... in managing investor relations." (The position paper goes on to make it clear that the responsibilities of the remuneration committee include managing the stakeholder relations with investors and other stakeholders deemed appropriate on remuneration matters at the annual general meeting and throughout the year.)


84% (83% in 2012) felt that shareholders have become more active in the remuneration affairs of the organisation.
C. Assessing the second AGM season under the current remuneration governance framework

Corporate governance conundrum?

Both pay design and pay level can and should be differentiators in the battle for talent. Innovation in pay design is a critical lever in attracting and retaining people with scarce skills and leadership potential. However, there is a growing risk that the current focus on remuneration policies will favour greater conformity when it comes to pay design. A remuneration approach that differs from the norms will attract more attention, requiring more disclosure and explanation.

Do you agree with the following statements?

Increased corporate governance should reduce pay practices that may be perceived as problematic, such as change in control payments, special severance payments or ‘golden parachutes’, tax gross ups, sign on or guaranteed bonuses, and ‘pay for failure’

Increased disclosure of executive pay will have unintended consequences, such as: the disclosure of sensitive or confidential information not in the interests of the company; the disclosure of competitive pay practices; the ‘ratcheting up’ of executive pay

The good: Last year, 43% believed that ‘increased corporate governance’ would reduce pay practices that may be perceived as problematic, like golden parachute payments and guaranteed bonuses, or pay for failure. This year, this percentage has markedly increased to 73%, making it a key take-away from this survey.

65% (62% in 2012) believe the first season of shareholder votes has been successful.

The bad: As much as 56% (2012: 50%) suggest that there will be unintended consequences of increased disclosure of their remuneration practices.

Overall, a majority of 65% (62% in 2012) believe that the second season of shareholder voting on the remuneration policy has been successful.
D. Measuring performance

Links between pay and performance are the key focal point of remuneration committees for 2013/14 (see section G). It follows that establishing the right metrics that best measure performance will also be top of the agenda.

In this year’s results, as with the 2012 survey, profitability measures were dominant across both short and long-term schemes.

Short-term schemes

Consistent with 2012, profitability and personal targets appear to be the most favoured metrics for short term schemes.

We see a drop in the use of non-financial measures from 47% to 35%. This is surprising, as the current shift to integrated reporting emphasises the need for both financial and non-financial metrics in measuring and reporting on corporate performance.

Long-term schemes

There is a marked increase over 2012 in the use of profitability measures in long-term plans, from 35% to 51%.

There is a noticeable drop in the use of total shareholder return (TSR) as a performance metric, from 31% to 24%. Perhaps this is in line with the continued criticism TSR has received mainly because the share price reflects factors outside the influence of the executives and also because it is subject to short volatility and market sentiment. We also see a drop in the use of non-financial metrics from 24% to 14%.

Setting challenging but meaningful goals and then calibrating the pay-out is not an exact science and will require in-depth understanding of the organisation's business and value drivers. Performance metrics that are tailored to specific strategic business objectives will be important to get right. It may be that we are beginning to see more experimentation and hence diversity in the selection and establishment of performance metrics.
Which of the following performance indicators are currently included in your long-term incentive schemes?

![LTI schemes diagram]

Which of the following performance indicators are currently included in your short-term incentive schemes?

![STI schemes diagram]

E. Vesting periods

What is the vesting period of your long term incentive schemes?²

<table>
<thead>
<tr>
<th>Average years</th>
<th>Minimum</th>
<th>Maximum</th>
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</thead>
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<tr>
<td></td>
<td>3</td>
<td>5</td>
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Thirty-five participants (69%) have a minimum vesting period of three years and 21 participants (42%) claimed five years as the maximum vesting period on their long-term investment schemes.

The range of three to five years is not unexpected. However, commentators and other stakeholders are starting to suggest that three years is not long enough. For instance, the Association for British Insurers in the United Kingdom is pushing for longer periods.

²These questions were not asked in the 2012 survey.
F. Remuneration policy: Level of disclosure

What level of employee does your disclosed remuneration policy cover?²

Based on our experience, this is a top question for remuneration committee members. Should they be devoting attention to remuneration issues at all job levels? Or should they apply their minds to just the top slice of executive management? Should they set targets for just the top management level, or should they include middle management level or even all employees? Is the corporate leave policy something that should concern them?

Based on the 2013 survey, the dominant view is that the remuneration policy should cover only issues relating to top management.

Our point of view is that the remuneration committee should ensure that there is a robust remuneration system covering all levels of the organisation, with all required components and supporting processes in place. The system would ensure a balance between internal equity and external competitiveness. With appropriate internal governance and oversight of the remuneration system, this approach would allow focus to be concentrated at the top management level.

This question points to the related issue of the wage gap in South Africa: the differential between the wages paid to the top and bottom earners in the company. The wage gap is one of the top three focus areas of the remuneration committee for the next 12 months (see section G).

²These questions were not asked in the 2012 survey.
G. Looking forward: Which areas will you place more focus on?

Looking forward, linking pay and performance remains in the top three focus areas together with performance conditions for incentive schemes and the wage gap. Noticeable changes since 2012 are:

- A decline in focus on the design of long-term incentive schemes from 62% to 21%.
- A marked increase from 16% to 33% in collaboration with other board committees such as the risk committee and audit committee. This substantial growth may be attributed to the increasing complexity of pay programmes.

**Areas of more focus in the next 12 months**

- Link between pay and corporate performance
- Performance conditions for incentive schemes
- The ‘wage gap’
- Share based incentive scheme design changes
- Reward strategy changes
- Review of proxy voting guidelines of institutional investor
- Short term incentive scheme design changes
- Pay considerations for all employees, not just the executive team
- Co-operation with other board sub-committees, e.g. Risk & Audit
- Remuneration benchmarking methodology
- Quality of information (breadth and depth) in the remuneration report
- Shareholder dialogue
- Links with enterprise risk management
- The pay mix for executives to more variable pay
- Peer group identification for remuneration benchmarking
- Long term cash incentive scheme design changes
- The Remco Charter
- The independence of remuneration consultants
- Pure retention schemes (i.e. with no performance element)
- Capabilities of Remco members
- Bonus deferral provisions
- ’Claw back’ provisions

Engagement can be an opportunity

“Companies can benefit by building trust, establishing a mutual understanding and maintaining constructive relations with investors. Companies may be able to secure support for proposals that they put to the shareholder vote. Companies also may be able to identify earlier in the process potential issues that require attention.”

Source: Ernst & Young, “Preparing for Shareholder engagement”, *BoardMatters Quarterly*, April 2013

*The ‘wage gap’ question was not asked in the 2012 survey.*
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