Guidance for Remuneration Committees

IMPACTS OF THE COVID-19 PANDEMIC ON REWARD PRACTICES
A SOUTH AFRICAN PERSPECTIVE

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The objective of the Forum is to serve as a platform for discussion and dissemination of guidance to remuneration committee members either in the form of papers or events.

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Introduction

The COVID-19 pandemic and the associated government regulations have caused a large part of the South African business world to go into lockdown for a prolonged period of time and most HR and Reward practitioners were faced with having to develop reward policies and processes for completely different business environments, in record times.

With the initial chaos starting to dissipate, and with the (largely unknown) impact still being envisaged to last for at least a few years, the focus has changed from the present to the future. As a result, many questions regarding the continued relevance of well-worn remuneration frameworks are currently being deliberated by the Reward fraternity. Balancing the interests of shareholders, executives and other stakeholders is possibly one of the most challenging tasks that the Remuneration Committee has, particularly during this unprecedented period.

There are a few fortunate organisations that are positively impacted by the COVID-19 pandemic or the recent macro-economic events. However, the majority of South African organisations are facing revenue, cost and balance sheet pressures that have resulted in, inter alia, dividend cuts, restructurings and retrenchments.

Many Remuneration Committees must decide on whether annual increases should be awarded, what to do with short-term incentives and long-term incentives (either in-flight or at the end of the performance period) and how to retain and motivate key employees with long-term incentives having lost significant value. Is this an opportunity to take a step back and reset the traditional reward structure which, over the past few years, has evolved into a combination of reward plans that have become complex, with arguably higher levels of inherent risk for the executive, potentially lower levels of executive emotional buy-in and criticism from society at large?

Purpose of this Paper

Although there are many matters being considered at the moment, this paper aims to provide guidance to Remuneration Committees on the following five key questions in the context of COVID-19:

a) Should changes in short-term incentives (STI) and long-term incentive (LTI) targets be considered during the performance cycle and/or at the end of the performance period?

b) What should Remuneration Committees consider in respect of new (post COVID-19 lockdown) LTI awards?

c) How should adherence (or non-adherence) to minimum shareholding requirements during this period be treated?

d) Is this an opportune time for a reset of the reward structure / model?

e) What consideration should be given to Executive quantums vs general staff quantums of pay, when general staff are more affected by reductions in pay or pay freezes?
When Remuneration Committees consider these key questions in the context of how COVID-19 has had a significant influence on all aspects of our daily lives, it is important to test the potential implications of outcomes of their deliberations through the lenses of the following stakeholders that often have a vested interest in the trajectory of remuneration strategies:

- Executives
- Employees (i.e. staff below executive management level)
- Shareholders or institutional investors
- Other stakeholders including suppliers, financiers, government and the society at large

The IoDSA’s Remco Forum has published a number of papers since 2013; in particular, the following papers should be read in conjunction with this guidance document:

- Paper 4: Linking pay with performance
- Paper 7: Paying for sustainable performance
- Paper 9: 10 Questions a Remco should be asking
- Paper 10: Linking executive pay to organizational performance

This paper should also be viewed from the perspective of the financial year-end date of the organisation. Organisations with a June financial year-end are currently making or have already made some very tough decisions in evaluating the performance of executives versus previously approved targets, specifically as company performance was profoundly impacted by COVID-19 in the second half of the financial year. Organisations with a December year-end will have to consider whether targets should be changed mid-flight in order to retain and incentivise executives to turn around the organisation and steer the ship through very difficult economic times. Ultimately, reward plans should be designed to incentivise the right behaviour that will deliver positive outcomes in the short, medium and long term. This goal has become more important than ever during this ongoing period of uncertainty.

Questions RemCos should be asking

QUESTION 1:

Should the Remuneration Committee consider making changes to the short-term incentive (STI) and long-term incentive (LTI) plan targets during the performance cycle and/or at the end of the performance period (i.e. retrospectively)?

All types of incentive plans, whether top-down or bottom-up in design will, in organisations that are negatively impacted by COVID-19, be undesirably influenced as the funding for these plans is diminished if not completely wiped out. In most cases, it is expected that ‘target incentives’ will not be achieved this year and in the majority of organisations, the quantum of incentives will be lower than the previous financial year.
The Prudential Authority in South Africa, requested that, in order to conserve capital, Banks not pay dividends to shareholders nor cash bonuses to executive officers and material risk takers. The guidance note was issued on 6 April 2020, after the majority of SA banks had already declared dividends and made decisions on cash bonus payments in respect of their 2019 financial year, so the impact of this request will mostly only be seen towards the end of CY2020.

Where dividend payments are suspended or cancelled, there is a general expectation by shareholders that executives will share this pain, albeit that executives also will not be receiving dividends and will likely suffer losses as a result of generally lower share prices and lower or zero bonuses.

Remuneration Committees can consider the following when deliberating this question:

i. How did the organisation perform, relative to others, considering the impact of the pandemic?

ii. Was the pandemic the only reason for the lower levels of performance?

iii. Did the executives immediately develop a turnaround or defensive strategy and were they reasonably successful in weathering the storm as a result of their swift action?

iv. Is this an ideal opportunity to reset targets for the remainder of a financial year, to ensure that the executive team remains focused on delivering the organisation’s (revised) key priorities and business plan?

v. Were there some targets, specifically non-financial targets, in the performance scorecard that were achieved and therefore deserve some pay-out?

vi. What is the liquidity or solvency position of the organisation – should shares be considered as an alternative to cash bonuses?

vii. Did the organisation have to retrench employees during the past or current financial year?

viii. Is the retention and motivation of key employees an important factor?

The following extract from the guideline to Recommended Practice 34.3.1, Principle 14, King IV, should also be considered:

“RP34.3.1

The structure of incentive plans

The structure of variable pay for executives should seek to moderate the impact of positive or negative factors that are completely outside of their control but influence the overall performance of the organisation. Examples of such factors are the platinum price for platinum mining houses, the international crude oil price for energy organisations, and the gold price for gold mining organisations. In such organisations, overall sustainable performance should still be targeted, within a mix of other financial and non-financial targets that are directly controllable.”

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1 Prudential Authority, Guidance Note N4 of 2020 - Dividends and bonus payments in response to Covid19

2 A guide to the application of King IV™: Governance of remuneration

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The responses to these questions, in the context of Principle 14, should provide guidance to Remuneration Committees in their deliberations. As a general guideline, it is mostly not recommended that incentive targets for short-term and long-term plans be changed in-flight – rather, the Remuneration Committee should use its discretion at the end of the financial year. However, in organisations that have a December or March year-end, there is sufficient opportunity to reset these targets in alignment with the revised business plan for the remainder of 2020, thus providing executives with some opportunity to ‘claw back’ on unmet targets and to be incentivized for generating value for shareholders in the remainder of the financial year.

The general view for LTIs is that the executives share in the upside and lose on the downside and that the exercise of any discretion by the Remuneration Committee with regard to resetting targets on previously awarded LTIs, would be difficult to justify. The nature of LTIs also means that previous awards can be left to play out beyond the immediate effects of the pandemic. Where Remuneration Committees do apply discretion with regard to allowing vesting of awards where corporate performance targets were not met, these decisions will have to be well communicated and justified to all stakeholders as recommended in the recent guidance from the influential global proxy advisors, ISS.

QUESTION 2:

What should Remuneration Committees consider in respect of new (post COVID-19) LTI awards?

There are three matters for consideration under this question:

i. Should annual LTI awards be made at the usual time during the annual calendar or should they be delayed?

ii. Should the issue price be set at pre-COVID-19 levels and if not, should the award size be adjusted to prevent windfall gains in the event of a rebound of the share price?

iii. Should corporate performance targets be set at the time of making the award or should these be delayed until there is more certainty about the economic climate?

Remuneration Practice Recommendation 170 supporting King III stated:

“The regular and consistent granting of share incentive awards and options, generally yearly, is desirable as it reduces the risk of unanticipated outcomes that arise out of share price volatility and cyclical factors, allows for the adoption of a single performance measurement period and lessens the possibility and impact of ‘underwater’ options or excessive windfall gains.”

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The guideline to Recommended Practice 28.3, from *A guide to the application of King IV: Governance of remuneration*[^5], states:

**“RP28.3**

The Remuneration Committee should ensure that the design of the variable pay schemes and the setting of associated targets do not encourage behaviour contrary to the organisation’s risk management approach, and does not unintentionally or intentionally drive excessively risky behaviour in pursuit of incentive targets.

The following practices mitigate the risk of unjustified rewards:

- **a. regular annual awards**, as opposed to **larger once-off grants**;
- **b. appropriate, multiple performance conditions**;
- **c. gatekeepers and modifiers**;
- **d. share awards such as restricted shares and performance shares, which are less leveraged than share options and share appreciation rights**;
- **e. longer vesting periods or, alternatively, holding or lock-in periods after vesting**; and
- **f. incentive malus and clawback provisions.**

Therefore, as indicated in the guidelines to remuneration in both King III and Principle 14 of King IV, regular annual awards are encouraged, even in these turbulent times. Although times are very uncertain, it is considered advisable for organisations to continue making annual LTI awards at the regular period, rather than to postpone until external circumstances become more stable – particularly as it is unknown when this will be.

In addition, this will also aid organisations’ efforts to retain their key staff who will likely become the target of headhunters and organisations that are not as badly impacted by the pandemic. The question therefore is not whether regular annual LTI awards should be made, but rather when relevant targets for LTI awards with 3 to 5-year vesting periods, should be set.

However, in the making these awards during the normal time frame, questions (ii) and (iii) should be deliberated.

Share prices globally have been hit by the impact of the pandemic and associated socio-economic lockdowns. In some organisations, share prices have already rebound to the pre-COVID-19 era and in these cases, this matter does not have to be considered.

[^5]: *A guide to the application of King IV™: Governance of remuneration*
However, if the organisation’s share price has dropped considerably due to the impact of COVID-19, and this is anticipated to rebound in the future, shareholders will expect Remuneration Committees to consider:

- reducing the size of the award to take into account the (temporary) reduction in the share price and minimise the risk of material windfall gains upon a share price rebound; or
- to use an averaged pre-COVID-19 share price in calculating the number of shares to be awarded for example a VWAP share price over a 6-month period pre the COVID-19 lockdown period.

With a lower share price, it is also likely that share usage will increase and the risk of reaching the limit for the share plan earlier than anticipated is increased, necessitating shareholder approval for an increased limit.

However, as it is virtually impossible to predict when and how much economies will recover, it is considered more prudent that the Remuneration Committee specifically states that it will exercise its discretion at the end of the performance or the vesting period, i.e. to consider the value derived from this year’s (and possibly also next year’s) annual LTI awards vs the real performance of the organisation.

Alternatively, this can be done is through capping the maximum value to be derived from the annual award (e.g. share price appreciation will be capped at 200%; performance targets will be capped at 100%), also referred to as the "value gain cap". The Remuneration Committee could request that specialists run various scenarios predicting share price performance as well as the extent to which corporate performance targets may be met in the future, to assist them in their decision making. An illustration of the potential consequences in terms of the total remuneration for executive management, displayed as a single total figure, of applying the Remuneration Policy at zero, minimum, on-target, and maximum performance outcomes, at various share prices, should be included in these scenarios.

As far as the setting of performance targets is concerned, these can either be set at the time of making the award, or within a reasonable time-frame (for example 6 months after the award is made). This time-frame should specifically be stated in the award letter.

Changing award sizes, the share price, the award date or the setting of targets as well as the use of discretion, must be in line with the remuneration policy, LTI rules, the trust deed, the Johannesburg Stock Exchange (JSE) Listings Requirements and the Companies Act, as appropriate.

Organisations that use share options or share appreciation rights, will have to consider what to do with these in-flight awards that may now be entirely underwater. The general guidance is that share option-type awards that are underwater should be left unchanged and that the new awards will most likely be made at a lower price which over time, will lock-in participants when the share price recovers.
QUESTION 3

How should adherence (or non-adherence) to minimum shareholding requirements be viewed?

Recommended Practice 30.3, from *A guide to the application of King IV: Governance of remuneration*[^6^], supporting Principle 14 of King IV, states:

“**RP30.3**

*Minimum shareholding requirements/guidelines should be considered by the Committee in the context of prevailing market practice and institutional investor feedback. This means that executives, in line with international practice, may be required to hold a certain percentage of their total guaranteed package or base salary in company shares in terms of beneficial shareholding — this intends to enhance alignment of interests with other shareholders, with a focus on long-term, sustainable company performance. The Policy requirement should be disclosed; the actual shareholding against such requirement/guideline should be disclosed in the Implementation Report.*”

Most large and medium size listed organisations on the JSE have adopted minimum shareholding requirements (MSR) for their executive directors and prescribed officers. It is incumbent on the Remuneration Committee to determine the period over which the executive is required to meet this requirement, and how the value of unencumbered shares held in personal portfolios by executives, is progressing towards the achievement of the MSR.

Organisations typically use one of three methods to assess compliance against the MSR:

- the share price at the time of acquiring the share;
- the share price on the last date of the financial year; or
- whichever is the highest of the previous two.

The response therefore will depend on the method adopted to assess compliance. If shares were previously acquired at much higher share prices, and/or where the MSR has already been met, the recent drop in share prices should not in itself pose a problem if the acquisition price is used to assess compliance.

For those executives still building up a value of shares to meet their MSR, the vesting of shares at much lower prices, and possibly at below target levels, will impede their ability to achieve the MSR within the prescribed time period. If this is the case, the Remuneration Committee is encouraged to consider extending the term to comply with the MSR, typically on condition that all shares that vest in the hands of the executive are retained until the MSR has been met. This extension should be communicated in the next annual remuneration report.

[^6^]: *A guide to the application of King IV™: Governance of remuneration*
QUESTION 4:

Is the time opportune for a reset of the reward structure / model?

Executive reward has become extremely complex over the past decade. There is growing belief that the link between performance and reward is not direct enough; and executive management believe they are not sufficiently rewarded for the risks they have to take. The Remuneration Committee is forever caught in the tension between these two parties and society at large is incensed at the absolute levels of remuneration paid to executives when there is an unemployment rate of ~30% in South Africa (which has increased further as a result of COVID-19 and the resultant lockdown). Few people believe that complex incentive plans contribute to the retention of executives – the need for simplicity is real.

Although there is certainly a school of thought that believes that there should be no knee-jerk reactions, and that Remuneration Committees should wait for at least another year to see how the pandemic will play out in global markets, there is certainly also a view that it is time for a more moderate approach to executive reward that consists of:

- guaranteed remuneration;
- lower on-target STIs payable upon achievement of a mix of financial and non-financial targets in a balanced scorecard; and
- smaller on-target LTI awards consisting of time vested shares without corporate performance conditions (i.e. restricted shares) with a longer vesting period than the current market practice of 3 years. Alternatively, a combination of restricted and performance shares but where the ranges of corporate performance targets are much wider than what is currently the case, making the opportunity for some vesting less onerous.

This means a more moderate overall remuneration package with higher levels of certainty and improved shareholder alignment. This pandemic has created fertile ground for change and a reset in remuneration policy. There are many industries that have already had to significantly reduce guaranteed remuneration, where the likelihood of increasing salaries in the near future is slim. Is this not the time to recalibrate executive reward to more societally acceptable levels, with stronger alignment on long term value creation for stakeholders?

QUESTION 5:

What consideration should be given to Executive quantums vs general staff quantums of pay, when general staff are more affected by reductions in pay or pay freezes?

Consideration should be given to the optics of the total remuneration package of executives relative to general staff particularly if there has been salary or guaranteed package reductions, unpaid leave for extended periods, pay freezes or redundancies in an organisation. Remuneration Committees may consider the reduction of STI and/or LTI pay-outs for executives even where targets had been met, in order to show solidarity with the financial losses experienced by the rest of staff. Salary cuts for executives should be considered in light of total financial losses experienced, also in variable pay.
Conclusion

In all instances, effective disclosure and the rationale for any changes to either targets during the course of a year, or the outcomes against those targets, as well as compliance with MSRs, will be critical to ensure that shareholders can evaluate any discretion applied by the Remuneration Committee. A strong rationale for such discretion applied will be imperative. COVID-19 has certainly taken its toll on society at large and the impact of the pandemic on executive rewards has to be in-step with stakeholder experience. Vanguard said it well: “Boards should...be thoughtful about the reputational risks that may be associated with awarding large payouts at the wrong time.”

COVID-19 has created opportunities for a reset on many fronts. Remuneration Committees should step back and evaluate their remuneration policies in the context of the new future and be bold in their decision making to ensure a balanced outcome between stakeholder gains and impact and executive rewards. This is a time when management has to demonstrate significant leadership and resilience and it is important that they remain focused on continuing to create positive value and outcomes. The remuneration policy is a strategic enabler to achieve this. The future will never be the same as the past.

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[www.iiodsa.co.za](http://www.iiodsa.co.za)  info@iodsa.co.za  +27 11 035 3000

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