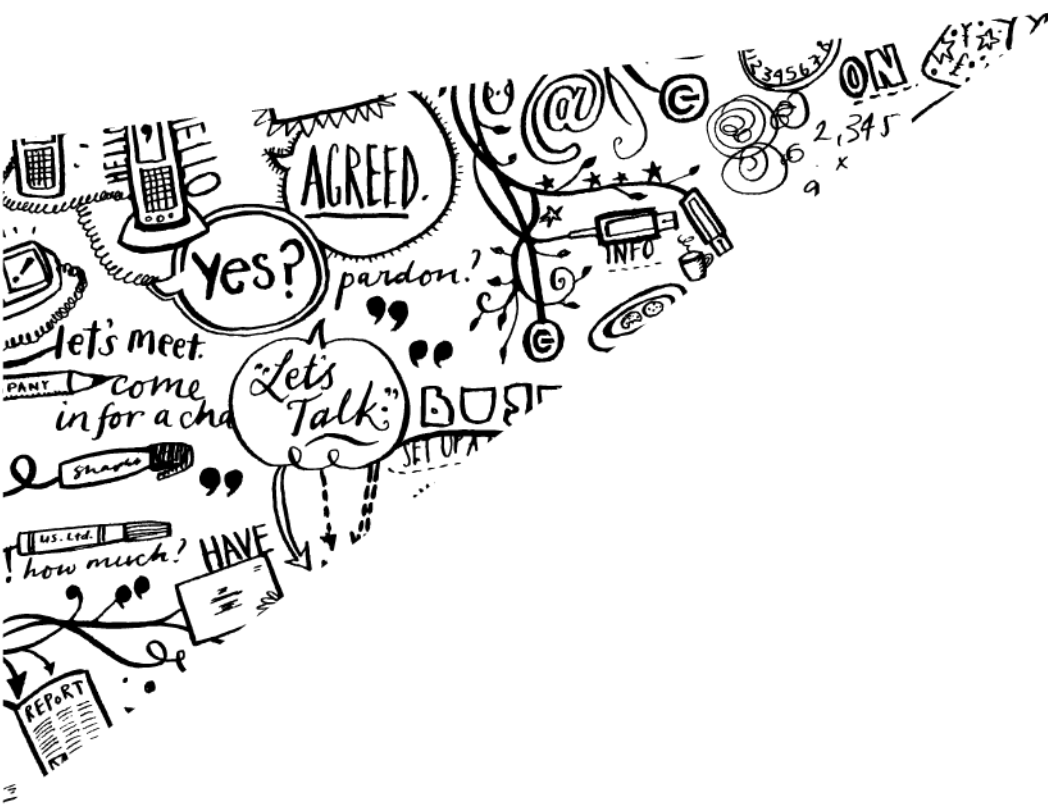


Implementing 2nd Pay Revision

Committee recommendations for CPSEs

HR implications and challenges





Introduction

In the backdrop of the recent 2nd Pay Revision Committee's (PRC's) recommendations for Central Public Sector Enterprises (CPSEs), and the subsequent approval of the Government of India (Office Memorandum No. 2(70)/80-DPE –WC), dated 26 November 2008, read with subsequent Office Memorandums, the issue of measuring and rewarding the performance of executives and non-unionized supervisors has become a significant HR intervention to drive a performance-based culture in CPSEs.

The notified guidelines mark a paradigm shift in the government's approach to Public Sector Enterprises. Some of the important cornerstones of this shift can be gauged from the following insights that emerge from the recommendations.

- ▶ Introduction of a Cost to Company (CTC) concept
- ▶ A performance management system (PMS) based on Key Result Areas (KRAs) along with specific measurable targets
- ▶ Differentiation of individual employee-level performance by the implementation of a bell curve approach
- ▶ Introduction of Performance Related Pay (PRP), based on the performance of the enterprise, on financial and non-financial metrics coupled with individual employee performance, aiming to achieve continuous performance improvement at the individual and organizational levels
- ▶ Formulation of a long-term incentive scheme in the form of Employee Stock Option Plans (ESOPs) to be paid as part of PRP

This presents a significant opportunity for CPSEs to set in place a performance-driven culture that is able to reward high performance. The government's directive however requires that the recommendations are implemented from the performance year 2007-08. Since this period is over, HR policy makers across CPSEs now face the challenge of quickly setting in place appropriate processes and systems that are in line with the recommendations.

Key HR challenges facing CPSEs

Driven by a strong government focus and a host of external and internal factors, CPSEs have grown and entered multiple industry sectors over the years. Many of them are witnessing tremendous growth and have ambitious business expansion plans that are ready for execution.

Our experience of working with many CPSEs reveals that although there is significant awareness of “Strategic Human Resource Management” as a concept, HR’s potential to become a strategic partner and agent of change is yet to be harnessed.

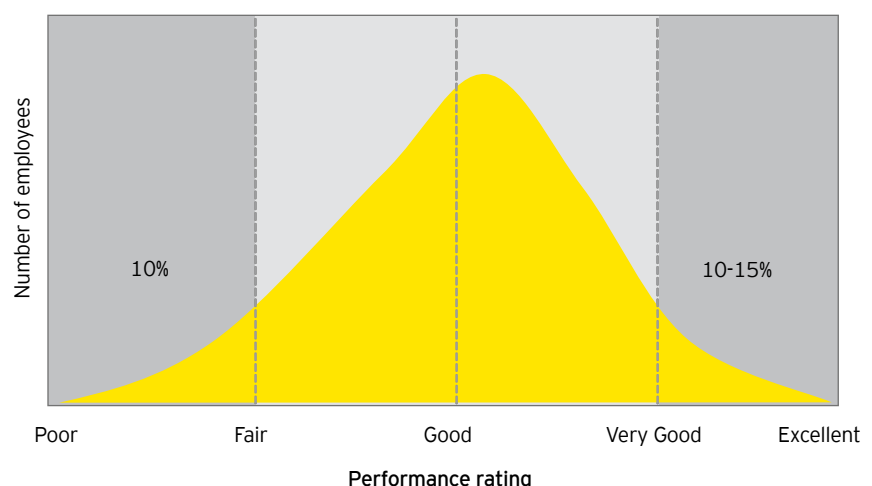
Some of the key strengths of CPSEs from an HR perspective:

- ▶ Presence of a range of HR programs that tend to be communicated effectively and are highly formalized
- ▶ Opportunities for impactful roles with rich job content
- ▶ Excellent perquisites and benefits offered to employees, enabling retention through high levels of social security

Some workforce-related challenges observed include:

- ▶ Significant competition from the private sector in hiring and retaining key talent
- ▶ Multiplicity of levels/grades resulting in slow decision-making
- ▶ Limited scope for autonomy due to greater focus on compliance and process adherence
- ▶ Need for establishing a stronger performance-oriented culture while ensuring rigor in adherence to the system
- ▶ Need for a greater focus on developing competencies for middle and senior management to build a strong leadership pipeline
- ▶ Significant scope for increased involvement of HR in the “business partner” role

Organizations will have to define the distribution of employees in this zone of performance



A bell curve-based distribution of performance ratings has been recommended by the 2nd PRC. While the distribution of “Poor” and “Excellent” has been fixed, middle-level distribution needs to be decided by PSEs.

HR implications of 2nd Pay Revision Committee's recommendations

The accepted recommendations of the 2nd Pay Revision Committee have substantial HR implications. The broad HR areas under which the recommendations can be categorized include:

1. Compensation structure: The CTC approach has been recommended for all CPSEs, along with the cafeteria approach for allowances, subject to an upper cap on the total payout. Therefore, it has become critical that various components of compensation are judiciously chosen and structured

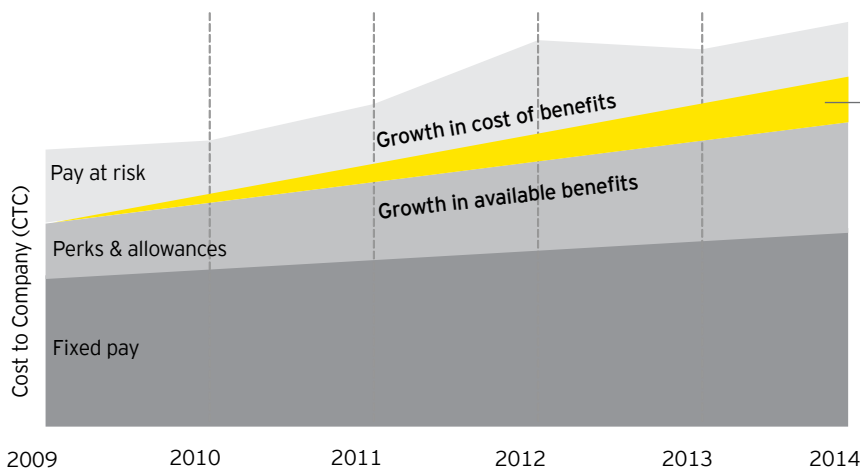
Another key implication is that the allowances, benefits, perquisites, etc., will have to be monetized and cost implications worked out every year to implement the 2nd PRC's recommendations pertaining to the upper cap on total benefits (50% of basic salary).

2. Performance Management System:

CPSEs need to put in place a robust and transparent PMS that is driven by performance against the identified key result areas at the individual and group levels. The recommendations also include putting in place a "bell curve approach" to grade employees. This requires:

- ▶ Enhanced levels of objectivity and transparency in measuring performance
- ▶ Reduced "rater" bias
- ▶ Robust business planning and target setting
- ▶ Distributions of ratings in organization at different functional/ regional/departmental level, in accordance with their performance

A pragmatic approach can enable organizations to leverage the opportunity at hand to achieve higher productivity.



Growth in the valuations of benefits will be greater than the actual quantum available to employees

This will necessitate regular valuation and update of the basket of benefits

3. Performance Related Pay:

Performance Related Pay (PRP) has been made an integral part of the compensation package and is to progressively become a major component of executive compensation. PRP has to be directly linked to the profits of the organization as well as the performance of executives. The immediate HR implication is to:

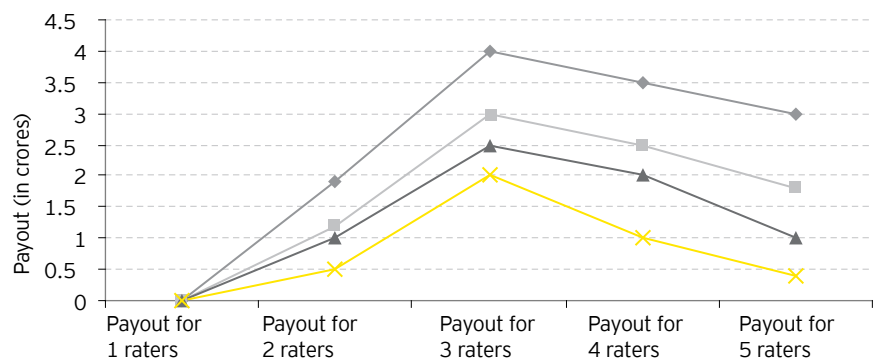
- ▶ Communicate to and educate employees and also support a change in their mindset about incentive payouts
- ▶ Shift from current group-incentive schemes to individual performance-based remuneration
- ▶ Develop a way to forecast the budgetary impact year on year due to PRP

4. Long-term incentives: All CPSEs will also need to formulate an Employee Stock Option Plan (ESOP) and 10-25 % of the PRP payout will have to be paid in the form of ESOPs or long-term incentives. For those CPSEs that are already listed on stock exchanges, this will necessitate the formulation of an immediate design of the plan with all requisite details such as the grant and exercise price, the vesting schedule, etc., in line with SEBI and other governing regulations.

Those CPSEs that are not listed on any stock exchange may need to seek clarification on alternative forms of long-term incentives that can be provided, so that this component of PRP is duly availed of by the employees.

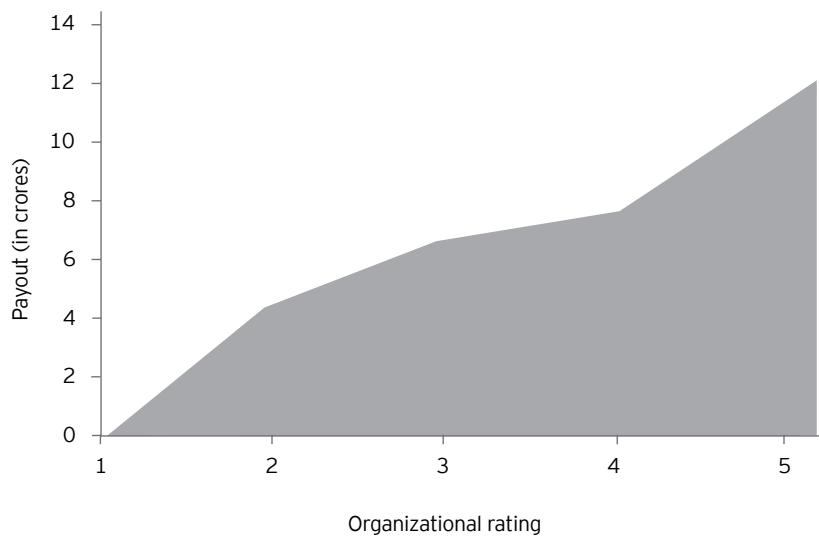
Payout at different Organization Performance

Illustrative



Total PRP Payout

Illustrative



However, it is important to understand that merely designing systems, such as those mentioned above, will not help to achieve real gains. A programmatic

approach to change will be the key for becoming more competitive through the enhanced productivity and motivation levels of the workforce.

Our understanding of current challenges in CPSEs

There are many examples of progressive Performance Management Systems (PMS) in CPSEs with a target-driven approach to measuring performance. However, in spite of many attempts, PMS is largely seen as a tool for promoting employees and not as a means to reward or differentiate performance.

PRC recommendations pose not only an HR system design challenge but a deep-rooted change management task, calling for a radical shift in how performance is perceived, managed and rewarded.

Organizations either find it difficult or are reluctant to clearly differentiate rewards on grounds of performance. In this light, the recommendation of forced ratings by using the bell curve method is expected to pose significant implementation challenges. Measurement of the behavioral aspects of performance is also tenuous with multiple definitions in the form of competency, values and potential, which are in vogue in most CPSEs. Further, the lack of a strong link between performance ratings and incentive payouts is one of the key reasons for weak implementation and employees not perceiving enough value in the system.

With respect to variable pay, attempts have been made by putting in place group incentive schemes. In most cases, these are mainly team-based targets, and hence, differentiating performance at the individual level is hardly the focus area.

The recommendations of the 2nd PRC have clearly laid out the principles that will determine the total program of performance-related payouts. However, the key to the successful implementation of PRP will be to look at it as a change management initiative that aims to bring about a fundamental shift in the mindset of employees. It calls for a gradual and systemic change, which begins with designing an appropriate performance management and measurement system with a clearly defined link between performance and rewards.

The concept of CTC is new to PSEs, although there have been isolated attempts to arrive at representative numbers, especially while trying to attract fresh talent from educational campuses. Due to the lack of precedence and in the absence of suitable guidelines and standards on how to monetize individual perks and allowances, there is the possibility of different PSEs adopting different valuations and thereby arriving at different CTC numbers. The readiness of CPSEs to perform valuations every year, to ensure that the basket of perquisites and allowances (as defined by the cafeteria approach) are within the prescribed limit, is low. There may be additional challenges in managing employee expectations if some of the existing benefits have to be discontinued to manage costs.

Illustrative

Saving and protection

Life insurance
Accident insurance
Superannuation

Consumption

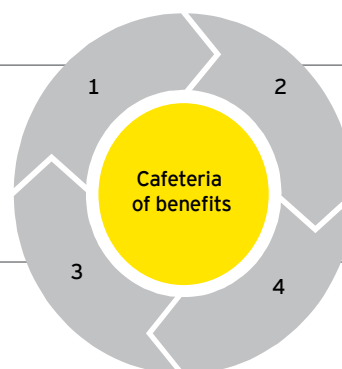
Gift vouchers
Computer purchase scheme
Subsidized loans

Well being

Medical check-up
Medical reimbursement
Hospitalization insurance

Lifestyle

Company leased car
Conveyance allowance
Meal vouchers
Club membership
Office wear allowance
Rest and recreation (Travel and stay)
Car maintenance and fuel reimbursement
Newspaper and magazine reimbursement



How can Ernst & Young help your organization?

Having served a wide cross section of Schedule A CPSEs over the years in the area of HR advisory, Ernst & Young has developed deep insights into prevailing challenges and issues pertaining to human resources.

We can provide support in the following areas, specifically in light of the recommendations of the 2nd PRC:

Design-related support:

- ▶ **Designing KRAs/KPIs:** Defining holistic KRAs/ KPIs from MOU targets and cascading them to departments and unique roles
- ▶ **Target setting:** Designing framework for robust target setting against KRA/ KPI to enable an equitable level of stretch
- ▶ **Designing a PMS:** Objectively managing employee performance and development throughout the year
- ▶ **Moderation of performance ratings:** Defining population clusters for fitment

of bell curve across grades, functions, locations, etc.

- ▶ **Developing performance-related pay systems**
- ▶ **Providing long-term incentive:** Designing appropriate ESOPs

Program Management Support:

- ▶ **PMS implementation:** Supporting successful roll out of new PMS in organizations while building their readiness to manage change
- ▶ **Facilitating rating normalization process**
- ▶ **Communication support:** Developing and implementing a communication strategy to manage resistance to change and create awareness of the concepts of KRAs, PMS, PRP, ESOPs, etc., through train-the-trainer workshops, user manuals and FAQs

- ▶ **Monitoring and review:** Facilitating the process of annual performance planning, mid-year reviews, final performance appraisal and the feedback process and also assisting organizations to conduct the moderation procedure for the distribution of performance ratings on the bell curve

- ▶ **Budgeting:** Developing the expected payout for different payout scenarios to enable effective budgeting at the beginning of the year; also helping to develop scenarios for the budgetary and P&L impact of implementing ESOPs

- ▶ **Capacity building:** Training HR staff to manage the new processes and systems and build organizational capacity to manage the change

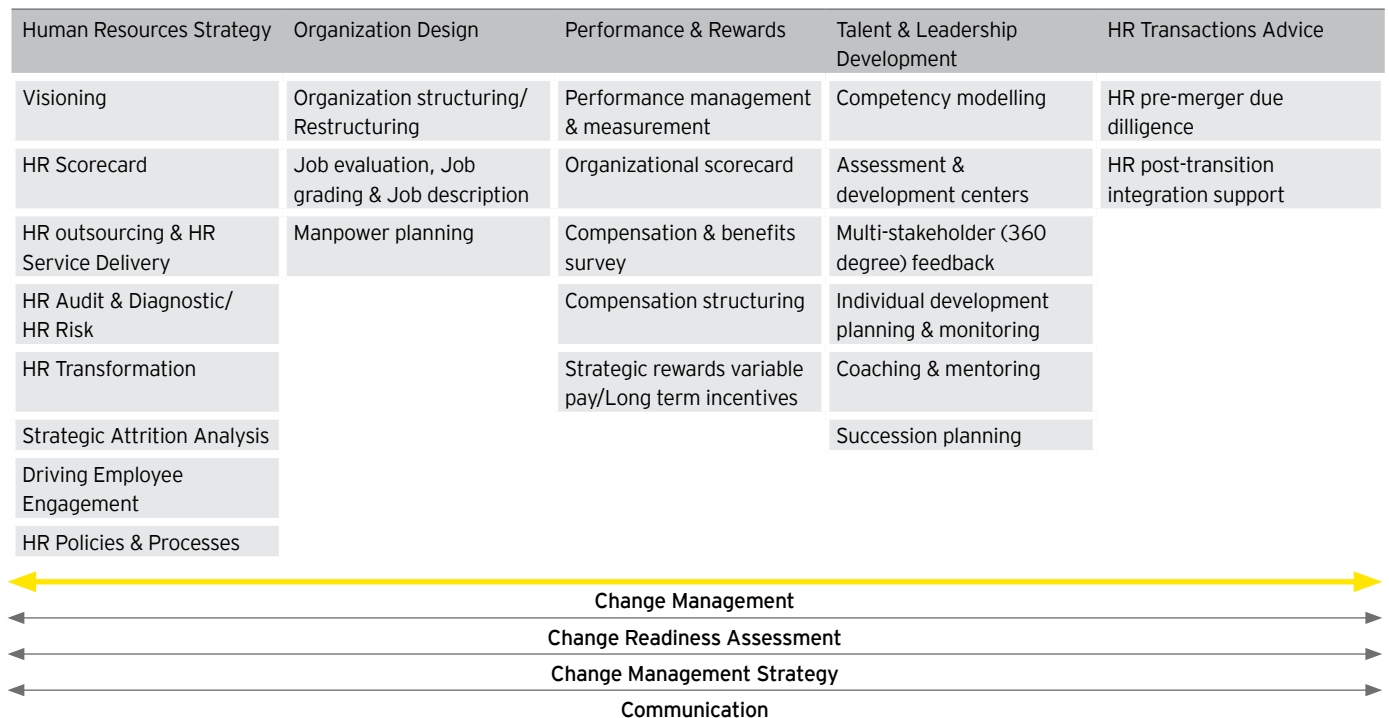


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Our support to the public sector in India in the area of HR is structured on our extensive understanding and experience of working with Public Sector Enterprises in India. We have served a significant number of leading CPSEs in the country in areas such as leadership competency assessment and development, performance management, design of rewards programs, organizational structures and HR systems and policy design.

Human Capital India: Our services offerings





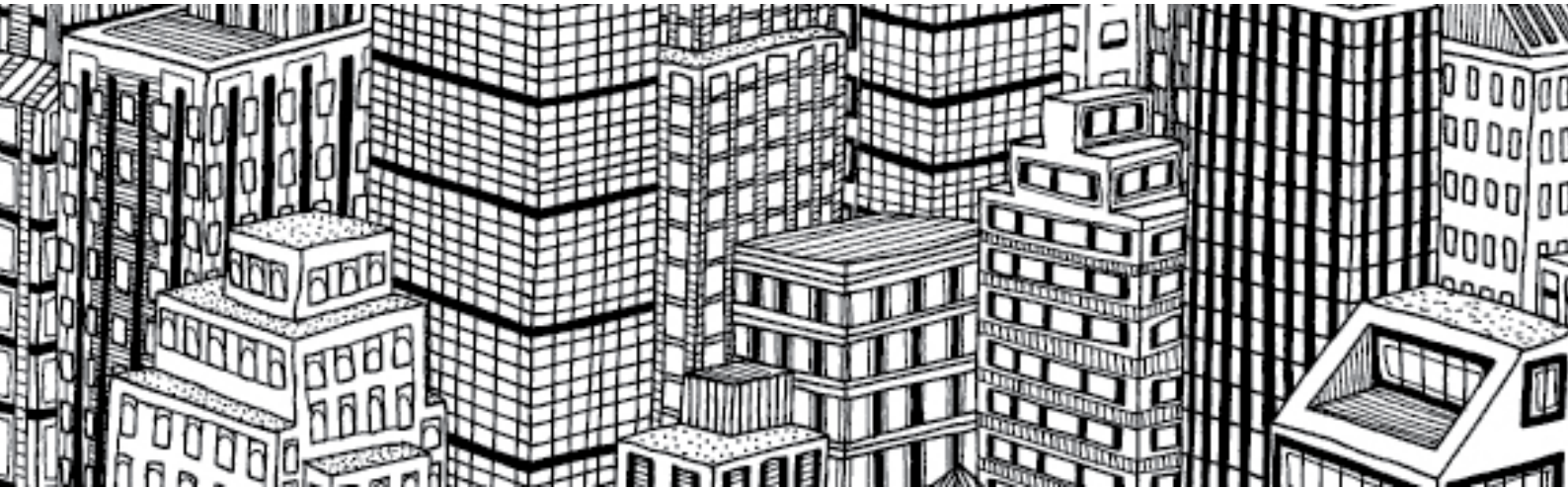
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