McLagan Alert

The Kingdom Reforms (Part II)

Saudi Arabia has announced a spate of cuts around compensation within the government and the public sector. While there may not be immediate ramifications of these curbs for the private sector, firms irrespective of their ownership structure, should be wary of these changing times. In this second part of the series, we explore what organizations in the Kingdom could do to effectively adapt to these circumstances.

Overview

The Saudi government has recently unveiled a slew of socio-economic reforms, many of which show a strong emphasis on asset creation across the economy. A number of state-owned investment entities are being institutionalized and revived, with a mandate to create jobs and ensure self-sustenance across a number of key economic sectors ranging from agriculture to heavy industries. The drive on asset creation has been coupled with curbs on financial excesses.

Such changes are being implemented from the top and include a reduction in ministers' salaries by 20 percent and in the lump sum offered to Shoura members by 15 percent. Overtime and bonuses have been capped for all government employees. The changes also include a reduction in the number of paid leaves, increase in the number of working days, suspension of annual increments, and an increased scrutiny around performance. For many ordinary citizens, there has been a newfound awareness around the sheer number of benefits and entitlements prevailing hitherto in the public sector.

It has been no secret that for most affected firms in the Kingdom, the pace of these changes has been as severe as the harsh economic climate. In general, firms with an excessive number of pay components do poorly at managing their reward systems. In fact, the piecemeal approach towards rewards often stems from an innate need to offer higher packages to help manage employee expectations. Thus, newer components of pay are often invented and added to the existing list with a view to justify compensation increases. All this is often done with a compromise around a philosophy on Total Rewards. Firms should consider a move towards consolidation of their reward structures – they will be better prepared to offer employees a holistic total rewards whilst ensuring the costs are kept under check. In our previous paper we have explored a few alternatives that firms could pursue in this regard.

How you can respond

McLagan works extensively within the GCC financial market. We work extensively with clients to help optimize performance management and executive compensation with an alignment to the overall reward strategy. We also routinely advise international and local clients in the region on other matters around compensation, performance and productivity.

For direct consultation on these topics, please contact us.

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Whilst the proposed changes for the ministers and Shoura members are unlikely to yield substantial cost savings, they are expected to usher in a culture of austerity and pragmatism with respect to compensation and employment decisions across various industry sectors. As such, the sectors that pay at the higher levels (and those with a government or a quasi-government ownership) such as petrochemical, banks, and investment firms may come under increased scrutiny. At the same time, the private sector may find it relatively easier to attract talent from the public sector – a domain young Saudis evidently prefer as a career destination for various reasons.

Given these changing circumstances, how should firms respond and how best do they take advantage of these tough times to build HR structures and processes that will help usher a new wave of growth? In our previous whitepaper we discussed organizational design, talent management, and rewards management as three critical components that firms in the Kingdom should focus on. In this paper, we explore two other components which relate to successful HR setups. Whilst our thoughts have been triggered by the recent events in the Kingdom, the proposed principles apply equally to other countries in the region which face similar challenges and economic climate.

Performance Management

In times of weak business and economic outlook, firms often direct their focus on managing top performers. With constrained budgets, Boards will look for companies to strongly align their pay to the performance delivered and will be increasingly reluctant to sign-off ‘open budgets’ for variable pay in the form of guaranteed payouts.

The issue for many Saudi firms is often the lack of proper systems and processes that allow them to identify and measure top performance and offer commensurate rewards. In many firms, including those in the private sector, the focus is on offering a package that works on a limited upside based on individual performance rating. Even firms within the financial industry that deliver relatively large proportions of total compensation, through variable pay often do not make a holistic assessment of performance before determining actual payouts.

Holistic assessment of performance management relies on four critical components – Performance Measures, Performance Management Process, Linkage to Reward, and Leadership. All these elements intrinsically link to one another. The first three components form the key drivers of performance management and the fourth acts as the single most important enabler for an organization.

Performance Measures

- Ensure that KPIs are derived directly from the corporate vision and mission
- Assessment criteria should be robust and measurable
- Strive for a proper balance between various types of measures – financial, strategic, operational, growth, people, etc.
- Senior management should participate in setting corporate and divisional objectives

Performance Management Process

- Ensure the appraisal process is well documented and communicated
- The process should be easy to use for all stakeholders; adequate support should be provided by HR
- The process should incorporate frequent feedback – once a year 'tick-box' process is passé
- There should be sufficient control mechanisms to enhance the robustness of the process

Linkage to Reward

- Ensure strong correlation between the outcomes of performance assessments and reward
- Drive explicit and implicit linkage of PM to various forms of Total Reward
- The performance management setup should help the organization mitigate various forms of risk

Firms in the region do not have a healthy track record of managing productivity and efficiency. In part, we see this issue stemming from weak HR systems and processes, including:

- Inefficient or less-than-optimal approaches to manpower planning and reporting lines that lead to distended organizational structures. These structures are often retained with little emphasis on linkage to the business strategy.

- Piecemeal approach to compensation often leading to more pay elements being institutionalized – this increases both the direct and indirect remuneration cost.

The combination of these two factors lead to escalated manpower costs (higher than required manpower numbers multiplied by higher than necessary total remuneration), thereby lowering productivity.

A holistic approach towards higher productivity necessitates a focus on multiple elements of HR. Whilst strategic manpower planning is a longer term solution, quick wins can be derived through performance management. Further, performance management acts as an important conduit for other HR solutions to be implemented. This is of particular importance in sectors such as banks and investment firms, where employee compensation costs are a significant proportion of the overall cost base.

Firms should consider incorporating suitable performance measures around employee productivity, such as employee cost to income ratio, into the firm-wide balanced scorecard. These measures are deployed on a relative basis – McLagan conducts extensive productivity benchmarking across several sectors within the financial industry.

In many cases, the HR function does not play a proper role around driving cost optimization and employee productivity. The first step towards bringing focus and attention to this topic would be to enhance the performance management system and make productivity an integral part of the corporate and HR scorecard.

Performance linkage to compensation systems need to be at multiple levels – corporate, divisional, and individual. The laissez faire approach of distribution bonuses as fixed multiples of salary at the end of the year, is unlikely to auger well with the discerning boards of the future. Similarly, sales incentive structures should enhance linkage to the achievement of the right market-aligned targets.

Executive Compensation

Executive compensation is likely to come under increased scrutiny in the coming months, given tight budgets and challenging overall economic climate. The challenge for many financial firms would be to deliver a larger portion of the total compensation as contingent pay – efforts need to be directed towards ensuring that the variable pay plans remain self-funded with strong line of sight to corporate results and individual performances.

Within the Kingdom and the broader regions, few firms give the right focus to long-term incentive plans. The current pay focus within many firms in the financial industry is as follows (commercial banks have sales incentive structures in addition to these):

1. High quanta of fixed compensation
   – Often referenced to the market on the basis of employee grades
   – Broken down into large numbers of allowances and benefits

2. Moderate annual bonuses
   – These are generally expressed as a multiple of basic or fixed pay
   – Generally delivered based on individual performance ratings without explicit adjustments for corporate and divisional performance

3. Negligible focus on long-term incentives

Where long-term incentives do exist, the plans are often governed poorly. We have noticed several firms establish robust structures only to cancel or adjust plans in later years with poor payouts! This reflects a culture of entitlement and drives expectations of almost guaranteed payouts; something of this nature would hardly be encouraged, especially within the financial industry, in most parts of the world.

Long-term incentive design in the region often suffers from two noticeable flaws:

1. They are backward looking and focus on historic performance levels
2. They fail to take account of long-term multi-year performance

Where possible, the delivery of incentives through a combination of cash and equity would better alleviate risk. The opening up of the Tadawul will lead to better transparency and higher trading volumes – cogent reasons to deploy equity-based compensation structures. Long-term incentives are great ways to deliver the right payouts whilst ensuring that the executive focus remains on forward looking multi-year performance. If properly structured, the plans would only payout if shareholders realize a growth in value. This alignment of interests between executives and shareholders would lead to better corporate performance and reduce the scrutiny around pay, unlike in the case of structures with guaranteed payouts.

The structure of executive reward should be well aligned to the performance management system, given how both components cascade throughout the organization. The usage of the right performance measures as the grant and vesting criteria is important. The right suite of measures helps alleviate risk and ensures strong shareholder alignment.

In Conclusion

The recent remuneration cuts in the public sector are likely to have far reaching ramifications on compensation governance across industries. Boards will want the respective managements to run a tight ship and focus on efficiency and productivity. It will be imperative to ensure that the compensation structures support and reward top performance. Establishing robust structures around performance management and executive compensation will go a long way in ensuring alignment between the interests of businesses and employees.

About McLagan

McLagan is the leading Performance / Reward consulting and benchmarking firm for the financial services industry. For more information on McLagan, please visit www.mclagan.com. Aon Hewitt empowers organizations and individuals to secure a better future through innovative talent, retirement and health solutions. For more information on Aon Hewitt, please visit www.aonhewitt.com.