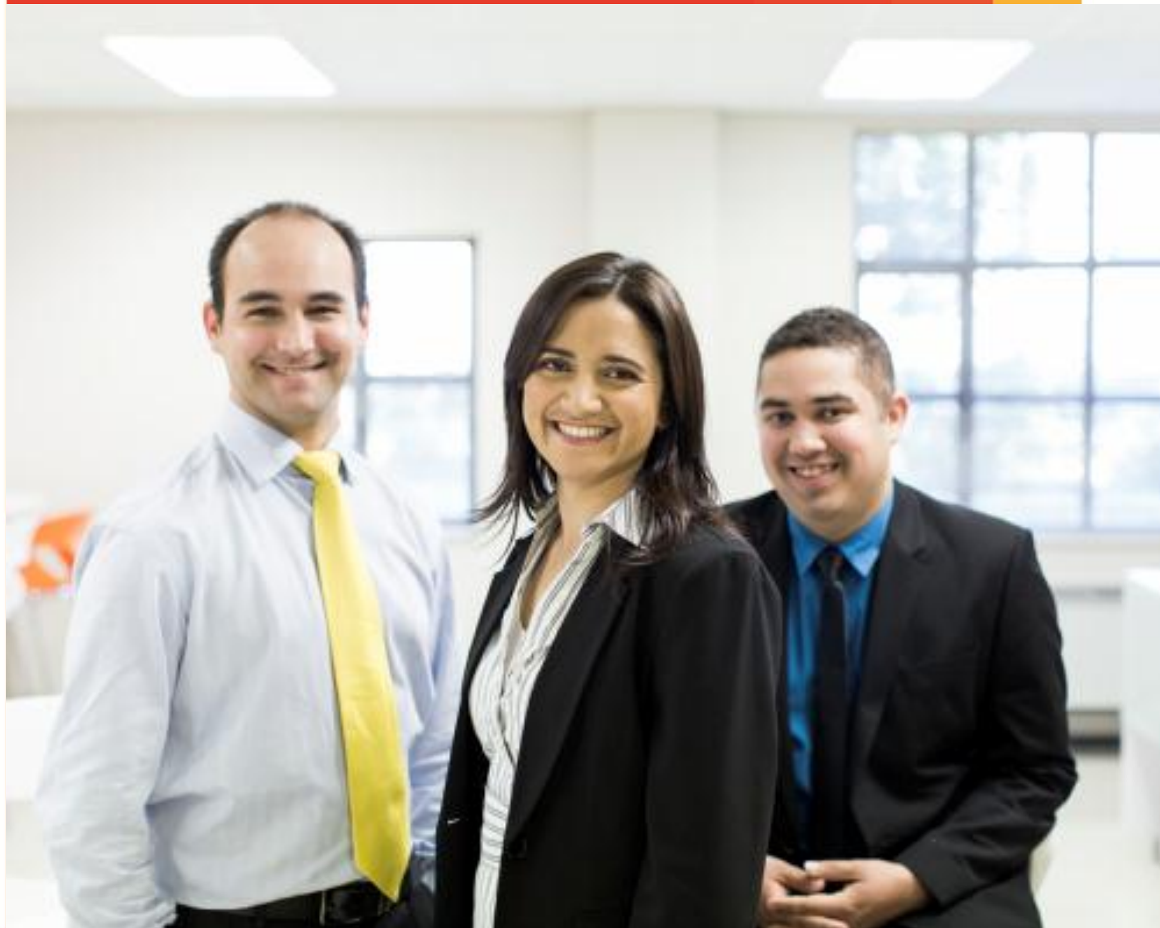
HR Quarterly

February 2014

A quarterly journal published by PwC South Africa, providing informed commentary on local and international developments in the Reward arena.



pwc

Contents

Human resources transformation: Is it driving business performance? 3

PwC Human Resource Services news 4

Resource planning: Looking to the year(s) ahead 7

Benchmarking and job evaluation – Are their importance increasing in the current economic climate? 8

Why paying for corporate high-flyers is coming back to earth 9

Retirement reform in South Africa 11

Current and forthcoming attractions 12

Contacts

If you require additional background on the published information, please contact:

Gerald Seegers
+27 82 655 7097

René Richter
+27 82 460 4348

Martin Hopkins
+27 82 459 4168

Karen Crous
+27 83 286 6960

Louna Robbertse
+27 79 494 3222

Carol Shepherd
+27 84 657 3526

Tumi Seaketso
+27 82 464 8126

Minda Botha
+27 83 787 4878

Human resources transformation: Is it driving business performance?

In a slow economy, organisational effectiveness remains one of the key elements to corporate survival. 'Transform or become obsolete' seems to be the order of the day. This may be easier said than done.

Our research shows that aggressive global expansion and changing workforce characteristics have elevated the importance of recruiting, talent management and performance management. While some human resources executives have transformed their administrative-focused organisations and regionalised departments to improve their strategic value to their operational and functional counterparts, many organisations fall short of true 'transformation'.

These organisations focus on efficiency, yet their business counterparts' strategic talent management issues go unresolved – with significant opportunity cost to market growth and other corporate initiatives. Following a transformation, does your human resources team focus more on the business than on administration? We suspect that in many cases it is the latter and not the former. If this is indeed so, changes to the manner in which human resources drive business performance can and must be transformed, given the current economic climate. Now is definitely the time for transformation to ensure future sustainability.

The PwC Reward Team

PwC Human Resource Services news

The benefit of having reviewed the practices of non-executive directors over the past six years is that it makes it possible to identify trends and predict the way forward with some degree of accuracy.

However, the extent of the changes now taking place, for example in the social and environmental arenas, means that organisations are moving into a phase that we can only best describe as 'business unusual', and thus predictions are becoming more difficult to make.

Corporates, listed or unlisted, private or public, are fast evolving into 'purpose-driven' organisations. Gone are the days of organisations having vision statements. It is now all about how they can build meaningful relationships with their respective stakeholders. This then begs the question in respect of non-executive directors – as a member of the board, do they support the organisation's purpose? Thereafter, they can assess how they will make a contribution to executing the organisation's purpose and ultimately ensuring that it behaves as a good corporate citizen.

For the first time, we look at aligning the organisation's purpose with executive remuneration and discuss whether or not there should be a link and if so, how strong this should be. As part of this significant change in business, we also see a major focus by organisations on defining their stakeholders and ensuring that they are properly engaging with them. Until now, everything has been about the shareholders and what return can be delivered to them. However, while this remains important, shareholders and management should now be equally concerned about who their stakeholders are and how they are engaging with them. The power of social media should not be underestimated.

Should you wish to obtain a copy of the survey, please contact Gerald Seegers at gerald.seegers@za.pwc.com or René Richter at rene.richter@za.pwc.com. We trust that you will find this publication of interest and will gain a better understanding of the issues, challenges and trends that we have raised and identified.

In the January 2014 Non-Executive Directors Survey we take a look at stakeholder engagement for the first time to give non-executive directors a better understanding of the risks they now face. Finally, in order to obtain an objective view of how directors are responding to the shift to integrated thinking and reporting, we share the findings of a survey undertaken by PwC among JSE company secretaries to see how they perceive board readiness in this regard. We also look at the remuneration adjustments of non-executive directors by major industry sector and company size.

Economic challenges and the impact of key economic indicators on wage movements during 2014

South African inflation – Are we going into an upward spiral?

Until the end of November, most organisations reported that budgeted overall lift to payroll would be between 6% at the lower quartile and 7% at the upper quartile, with an average of 6.3% reported in the September 2013 PwC Salary and Wage Movement Survey.

During the first few weeks of 2014, the South African Reserve Bank was widely expected to leave the bank's benchmark repo rate on hold at 5,0%. According to a Reuters poll late last year, economists were split virtually evenly on the central bank's future plans. Of the 34 economists surveyed, 17 expected officials to leave rates unchanged for the remainder of 2014, while 16 expected a rate hike by year's end. One forecast a rate cut. And then we were overcome by the sudden depreciation of the rand and, of course, the adjustment of the key repurchase rate by the Monetary Policy Committee (MPC) during the week of 27 January 2014 to 5,5%.

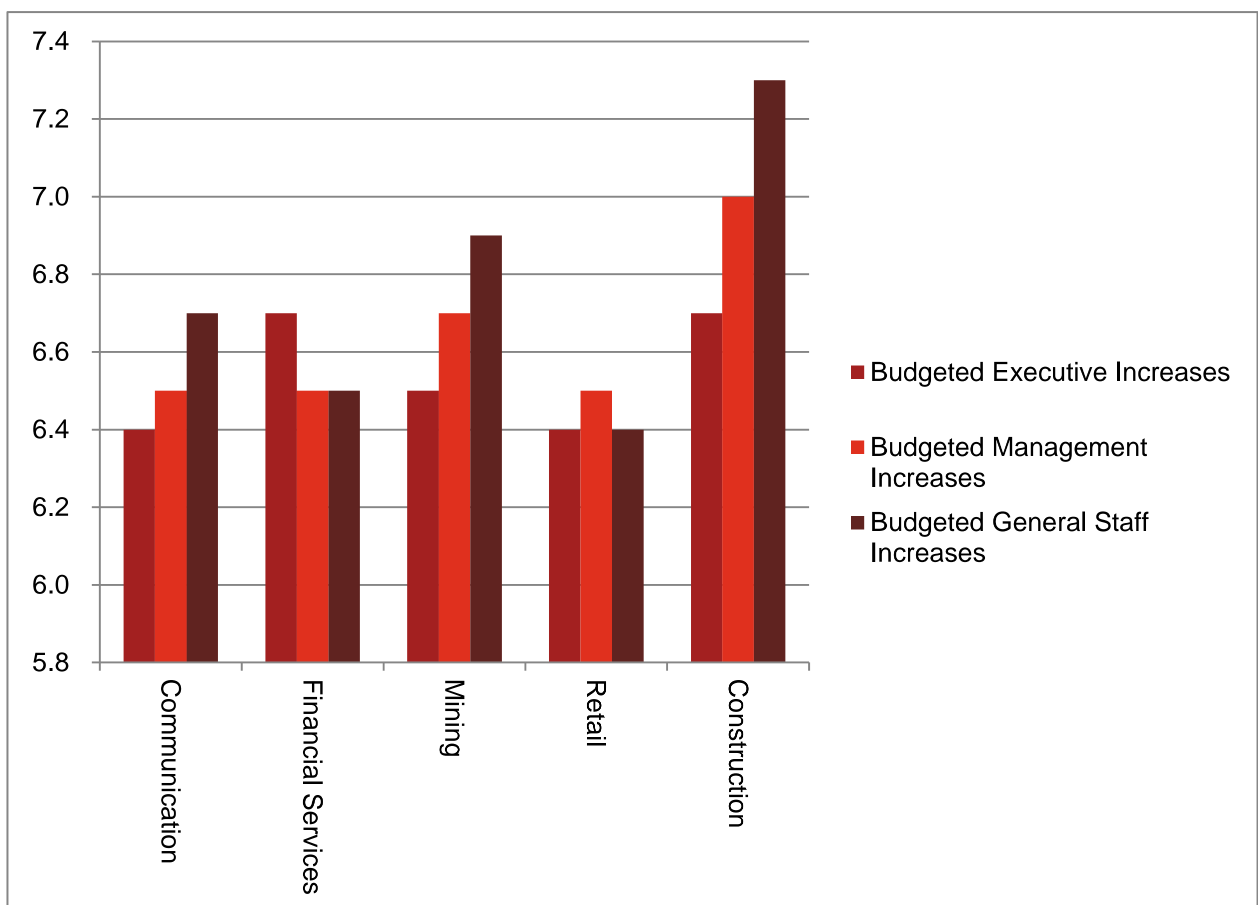
On the consumer price index (CPI) inflation front, the Governor of the Reserve Bank indicated that she expected CPI to increase to 6,3% post the repo rate increase. Most of the CPI forecasts late last year are now starting to seem quite conservative.

The three key factors to watch here are the rand, inflation numbers and inflation expectations. The risk attached to the latter two variables is that they can potentially surge as the rand slides.

What other factors will impact increases in the coming months?

- The outlook for the South African economy has not improved. Weaker GDP growth, unresolved domestic labour issues and new global concerns have a worrying effect on the prospects for 2014 and beyond.
- The drive from organised labour to obtain maximum salary increases has created an unsettling economic and political climate in South Africa.
- Due to the upcoming general elections in April, concerns around the volatile labour environment may only receive the needed attention later in the year.
- Against the backdrop of the global economic climate the South African economic growth forecast has now been adjusted to 1,9% for 2014.

The graphic illustration below compares the predicted total guaranteed package movement in a few of the major South African industry sectors, based on information extracted from REMchannel® as at 31 December 2013. Interestingly, at the time the construction industry sector predicted the highest management and executive increases for the next 12 months. This is, however, only marginally higher than the overall average of 6,8% as anticipated by our national all-industry sector participants. It is also evident that the retail industry sector predictions were conservative and could probably be an indication of the spending patterns by consumers.



The March 2014 Salary and Wage Movements Survey will provide some fresh insight into the anticipated budgeted increases of South African organisations.

Should you wish to participate, please contact Norma Mayimela at norma.mayimela@za.pwc.com.

Resource planning: Looking to the year(s) ahead

The beginning of a new year is a good time to reflect and look at the year ahead: Reflect on what you have learned from the past year and set new goals or modify old ones, depending on what you want to achieve in the year to come.

While you are at it, you should look further than the approaching year. There is no better time than at the beginning of a new year.

What to consider when setting long-term goals

- The company's strategy: What is the ultimate goal this year and in the coming five years – not only the figures but also the changes needed and resources required?
- The company's environment: What is happening in the economy? What are your competitors doing? What are the national and global trends that need incorporating?
- Planning for resources: What is needed in the long term to achieve the goals? What are the expected demographics? How will your current workforce develop itself?

The millennials are here and there are more to come

When planning for your resources, it is imperative that you consider the millennials as well. In 2020, half of the total work population will consist of millennials. Millennials, or Generation Y, are persons born between the early 1980s to the early 2000s. The fact is that your current workforce already consists of a considerable number of these youngsters. However, the following illustrates the need to focus even more on millenials, now and in the future:

- At any given point of time, your workforce may consist of three generations of employees: the millenials, Generation X and the baby boomers. Each generation has its own needs and desires.
- Millenials are IT-savvy: they see the use of modern communication in the workplace as a must and are used to instant replies while using these communication functions, whereas baby boomers are less in favour of the 'modern' communication styles.
- To attract the new generation is not easy. A company is as attractive as its brand, and to hold on to them is even harder.
- The world is becoming more and more global: 93% of the African millennials want to work abroad and 94% expect to work across geographic borders, more so than their parents.

Each point in itself gives rise to its own strategy – definitely something to consider while setting your long- and short-term goals.

Benchmarking and job evaluation – Are their importance increasing in the current economic climate?

There seems to be a greater emphasis on the sizing of jobs to measure internal and external equity. Not only does it ensure fair pay; it also provides the ability to manage the largest cost of organisations more effectively.

Benchmarking and job evaluation are the two tools that reward professionals use in the effective management of remuneration. In many organisations these tools formed the cornerstone of the reward philosophy for decades. However, prior to the economic meltdown many organisations entered a war zone – the war for the best talent created an environment where job evaluation seemed less relevant and benchmarking was used to a lesser extent. Many of our clients simply paid what they needed to pay to attract and retain the key staff in their organisations. This is not unusual, as the basis for a free economy is supply and demand. However, this created many anomalies in the traditional pay structure, and of course employees questioned the fairness of the pay practices.

Then came the meltdown – employers started cutting back on costs, and the salary and wage bill was the first to be reviewed. Many organisations realised that their pay structures were almost obsolete and that the pay ranges for each of the hierarchical levels or pay grades had increased to such an extent that it would take decades to 'fix' the problems associated with this phenomenon.

Although organisations still need to attract and retain the best talent, sanity is starting to prevail. This has created an environment where the first port of call is to fix the pay structures by going back to basics. The first step in addressing the anomalies is to evaluate the jobs in the organisation. This is a long process and takes dedicated resources to complete, but if it is not done consistently it can do more damage than good. Once the process has been completed the pay scales are reviewed, depending on the reward philosophy, which must of course be aligned to the business strategy. The comparator market and quartile are identified, a new pay structure is designed and employees are plotted against the new scales. At this stage most reward professionals are horrified by what they find! Pay for the similarly graded jobs sometimes ranges up to 500% – just imagine what a cost-of-living increase will do to these percentages over a period of time and how it will affect your employees' perception of fair pay. Not to mention how it will increase the salary and wage bill in an economic climate where all costs are being reviewed.

We are of the view that benchmarking and job evaluation are increasingly being recognised by our clients as the tools to manage remuneration costs effectively and create an environment of fair pay.

Why paying for corporate high-flyers is coming back to earth

Research shows that pay levels have converged – global benchmarks can no longer be used to argue for ever greater rewards **– Tom Gosling, Partner and Head of the Reward Practice – PwC UK**

In 1976, the Harvard Business Review published an article entitled *The 'devaluation' of the American executive*. It bemoaned a decline in executive pay over the previous decade which, its author wrote, was "probably here to stay".

Executive pay doubled

The world sometimes changes in unexpected ways. Since the turn of the millennium, executive pay has doubled in the UK in real terms, while average earnings have increased by only 10 per cent. Yet there are signs that the latter trend may be stalling. Bonuses paid to FTSE 100 chief executives have fallen in each of the past two years and salary freezes have become commonplace. Many believe this is a blip and expect executive pay to begin increasing once the economy recovers. I disagree. The forces that drove executive pay higher are abating or going into reverse. Executive pay is likely to stagnate in real terms, and may even decline.

Global competition is the reason that is given most often for high executive salaries. Companies that do not match the pay offered by foreign rivals risk ending up without their first choice in the boardroom, but the globalisation of executive pay levels has run its course. Research shows that pay levels have largely converged, with levels declining in the US as they have risen in Europe and emerging markets. International benchmarks can no longer be used to make the case for ever higher pay.

By 2004, four out of five FTSE 100 companies used at least two long-term incentive plans; one in five used three. But these contracts are often fiendishly complicated, leaving executives uncertain how much they are likely to be paid. Higher rewards have been used to compensate for the uncertainty. However, many corporate leaders would rather be paid less in exchange for greater certainty.

Increasing complexity of pay packages

Some have rightly pointed out that the increasing complexity of executive pay packages has also helped fuel the rise of incomes at the top. Amid concerns about rising executive pay, the 1995 Greenbury Report made recommendations about how to link executive pay to performance. Following this, many companies introduced long-term

incentive plans alongside existing share options. By 2004, four out of five FTSE 100 companies used at least two long-term incentive plans; one in five used three. But these contracts are often fiendishly complicated, leaving executives uncertain how much they are likely to be paid. Higher rewards have been used to compensate for the uncertainty. However, our research shows that many corporate leaders would rather be paid less in exchange for greater certainty. The revolt by shareholders against complexity has already begun in the UK. It is likely to result in executives being paid less, but in a simpler form.

As the attraction of the 'star chief executive' has waned, companies are investing more in succession planning. Three-quarters of new chief executives in FTSE 100 companies in 2013 were promoted from within the ranks. In the past year these internally appointed chief executives have on average received a salary 13 per cent lower than their predecessors. These modest awards will be reflected in benchmarks that are widely used to calibrate executive pay. This will have a restraining effect.

Finally, there is no doubt that regulation has a role to play.

Research shows that pay in financial services companies tends to be inversely correlated with the intensity of regulatory intervention. As banking was deregulated, bankers' pay increased. The current regulatory focus will put this into reverse. Pay in investment banking has already fallen by almost 40 per cent relative to other occupations since its peak in 2010, and it is likely to fall further during the next decade.

We are now looking beyond regulation at bigger trends that are not in the gift of government. During the past 35 years, the share of profits in gross domestic product has grown relentlessly at the expense of wages paid to labour. And as the share of profits grows, so does executive pay. But what goes around comes around. Just as 1976 turned out to be a high-water mark for wages as a share of GDP, so 2013 could turn out to be a high point for profits, and hence executive pay. All of the post-war gains for labour have now been reversed. The profit share could well have reached its peak, or at least a plateau.

There is a lesson here for policy makers. It is easy to imagine that recent trends will carry on for ever unless governments act to stop them. But the world is often a confounding place. Whether executive pay goes up or down will to a degree be determined by forces beyond the ability of governments to shape.

Retirement reform in South Africa

National Treasury wants to reform the retirement industry to improve the level of retirement savings, thereby reducing the burden on Government of providing old-age pensions. The reform will further lead to increased savings, which in turn would also stimulate economic growth.

Most employees who reach retirement do not have sufficient savings to ensure a sustainable standard of living going forward.

During 2012 and 2013, a series of papers was released to identify the key areas of concern that will be addressed as part of the retirement reform:

- Current tax regime is too complex, with three separate tax dispensations for the treatment of contributions to and benefits from retirement funds.
- Rates of preservation on exit are low, and cashing out accumulated retirement savings prematurely erodes security in old age, increasing reliance on others.
- Positive non-retirement savings culture should be encouraged through appropriate incentives.
- Current drawdown rates for living annuities(1) are too high, which will ultimately lead to inadequate benefits not keeping up with inflation. Further, living annuities do not provide any longevity protection.
- Charges in South African retirement funds are too high, eroding the savings of members.

---

(1) Similar to a bank account – purchaser bears the risk of the underlying assets and the risk that they will outlive their assets. These products must pay an income of between 2,5% and 17,5% of the account value to the policyholder each year.

Improving tax incentives for retirement savings – 2012

With effect from 1 March 2015, the tax regime will be harmonised across all types of retirement funds. Contributions to any retirement fund will be taxed as a fringe benefit in the hands of employees. The sum of employer and individual contributions will be tax-deductible for an employee up to 27,5% of the greater of remuneration or taxable income, up to a maximum of R350 000. Deductions will include the cost of risk benefits. Employer contributions to a defined benefit(2) fund will be valued through the application of a formula.

Further considerations are still needed for the refinement of the formula; how to treat hybrid(3) schemes; the funding of deficits; and surpluses applied for benefit improvements.

Preservation, portability and governance for retirement funds – 2012

It is found that most members do not preserve their benefits when they change employment. Further, annuitisation of provident fund savings at retirement is completely voluntary. Provident fund savings could be squandered quickly, while at least two-thirds of pension fund savings at retirement need be annuitised. Preservation for provident funds will be introduced from 1 March 2015 (T-day). This will occur through gradual annuitisation that will only apply to new contributions after T-day, subject to a minimum of R150 000. Individuals younger than 55 will be affected, and their vested rights will be protected. The means test, which has historically discouraged savings, will be phased out by 2016.

Current proposals to improve preservation include the following:

- Each fund should have a preservation section where a member's benefit will be transferred on leaving employment. Exiting members will still be able to access their benefit but only upon seeking advice.
- There should be compulsory membership of retirement funds, with automatic enrolment for formal employment.
- Trustees should guide members through the retirement process, and advice should be given commission free.
- Providers other than life offices should sell living annuities, which will increase competition.

Retirement funds place great reliance on the expertise of pension fund trustees in a financial world that has increased in complexity. However, a 2007 PwC survey on the effective management of South African retirement funds found that trustees often lack the competence to make investment decisions. The study further found that employee trustees are often chosen without consideration of skills and knowledge.

---

(2) Benefits are pre-defined, usually as a percentage of salary and service as oppose to defined contribution funds where contributions are defined with the ultimate level of benefit not known.

(3) Funds which have both defined benefit and defined contribution type benefits

A 2012 PwC survey, titled *Today's decisions, tomorrow's rewards: Retirement fund strategic matters and remuneration*, found that there was a great disparity in skills between employer and employee trustees, with 56% of employer trustees having more than 10 years' experience as retirement fund trustees compared to only 13% of employee trustees. Proposals to improve governance include making PF Circular 130 an enforceable regulation. This would make the Trustee Toolkit issued, by the Financial Services Board, a legal requirement. Further, it would give the Principal Officer of Funds an executive role in the day-to-day running of the pension funds. However, it is currently not clear how proposals to improve governance will be implemented.

Incentivising non-retirement savings – 2012

To encourage non-retirement savings, equity-based or interest-based savings accounts are proposed. The current thresholds for interest income tax exemption will be phased out. Contributions will be made out of after-tax income, subject to an annual limit of R30 000 and a lifetime contribution limit of R500 000. These limits will be adjusted with inflation over time. Implementation is expected in 2015. All withdrawals and returns earned will be exempt from tax.

Enabling a better income in retirement – 2012

The current conventional annuity[(4)] market is functioning reasonably well. Annuities are rated by age and gender but not by health or wealth, to the detriment of the poor and those in poor health. A matter for concern is, however, that 90% of policies sold are level annuities with no annual increase. Inflationary-guaranteed increases have also proven to be expensive.

Living annuities have high fees and lack longevity protection. Furthermore, current drawdown rates are too high (permissible 2,5% to 17,5%), are not Regulation 28-compliant and offer investment choice. It is found that individuals have difficulty in

4 Provide an income for life, guaranteed by an insurance company or a pension fund regardless of how long the purchaser lives.

deciding the drawdown rate, and few exercise investment choice but this option greatly increases the fees.

The pre-retirement support systems for individuals are withdrawn at retirement, when they are left to the retail market. It is proposed that living annuities be reformed by having a default product at retirement. The following simplifying design considerations would curb costs and increase protection:

- No investment choice; transparent charges; simple design.
- Not permitted to withdraw assets too quickly, and some longevity protection.
- Have transferability, with commission paid only on first two transfers.

The simplified default product would aim to remove the regulatory burden on the provider in terms of solvency, administration and product constraints, which should reduce costs.

The level of charges in the South African retirement industry is significant when compared to international counterparts. It is difficult to compare plans and options due to the complexity of products.

Charges in South African retirement funds – 2013

The level of charges in the South African retirement industry is significant when compared to international counterparts. It is difficult to compare plans and options due to the complexity of products. As a marketing tool, upfront charges are kept low and costs are shifted towards recurring charges that may appear more palatable. There is no regulation requiring the regular disclosure of fees to fund members although it is recommended. The level of fee disclosures to members in stand-alone retirement funds and umbrella funds is low, and yet in smaller less-well-run funds charges may be high. Active management often leads to higher fees. Financial intermediaries increase complexity and costs, and investment platforms have layered charging structures that make it difficult to assess the level of fees paid. Greater participation in the system, higher rates of preservation and a smaller number of funds would reduce costs through economies of scale. Effective intermediation which meets the needs of individuals, rather than targeting the highest commission, should be encouraged. A simplified fund design with fewer options would further reduce costs.

Financial wellness

The current provident fund environment leads to insufficient savings in retirement because of inadequate contribution levels and lack of preservation on exit. Even before understanding these issues, one should consider that inappropriate financial decisions can often increase the financial pressure experienced by employees. This will directly impact their productivity and the employer's profitability, as employees will not be engaging fully in day-to-day duties.

Globally, more and more employers are starting to focus on financial wellness, recognising their role in offering appropriate guidance and employee benefits. Not only will this benefit employees, it will also allow the employer to maximise value from all the employee benefits and employee assistance programmes offered. Reduced levels of stress for employees with a resulting increase in productivity and profitability, will be a win-for-all.

For more information on the retirement reform and the impact on your organisation, contact Nanie Rothman at nanie.rothman@za.pwc.com.

Current and forthcoming attractions

The following thought leadership and survey publications have been released or will be released in the next few months. Should you wish to download a copy of any thought leadership, please go to our website www.pwc.co.za and select the "Publications" tab. For enquiries regarding survey publications, please contact Margie Manners at margie.manners@za.pwc.com.

Surveys

- Salary and Wage Movement Survey (1st Quarter 2014)
- Long- and Short-Term Incentive Survey (4th Quarter 2014)

Thought Leadership

- The Global State of Information Security Survey 2014 (October 2013)
- Paying Taxes 2014 (November 2013)
- Global: Investors want more information on corporate governance (December 2013)
- Annual South African non-executive director thought leadership (January 2014)

© 2014 PwC. All rights reserved. Not for further distribution without the permission of PwC. "PwC" refers to the network of member firms of PricewaterhouseCoopers International Limited (PwCIL), or, as the context requires, individual member firms of the PwC network. Each member firm is a separate legal entity and does not act as agent of PwCIL or any other member firm. PwCIL does not provide any services to clients. PwCIL is not responsible or liable for the acts or omissions of any of its member firms nor can it control the exercise of their professional judgment or bind them in any way. No member firm is responsible or liable for the acts or omissions of any other member firm nor can it control the exercise of another member firm's professional judgment or bind another member firm or PwCIL in