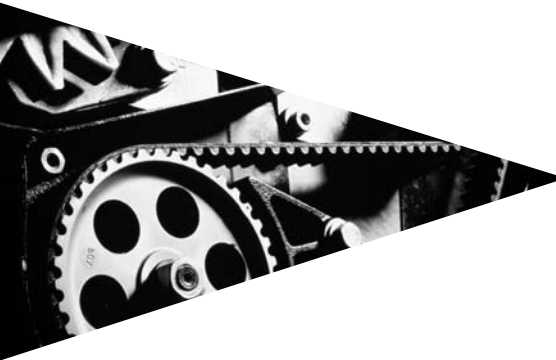


High Performance



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Welcome to the October edition of 'High Performance', Ernst & Young's Performance & Reward quarterly newsletter.

As you may have read, from 1 July 2008 Ernst & Young brought together 87 national practices to create our Europe, Middle East, India and Africa (EMEIA) business. In order to mark this event, our newsletter includes contributions from colleagues in the newly enlarged EMEIA business.

In our first article, 'The best of times and the worst of times...' I look at some of the key HR and Reward issues surrounding the current financial contagion.

In 'Restructurings and lay-offs: The importance of being earnest with Works Councils', my colleague, Roselyn Sands from our Paris office, explains to potential buyers the importance of the information and consultation process and why it must be factored into the deal timeline.

Ksenia Kamenskaya from Ernst & Young Moscow casts her eye over the latest development in the Russian labour market and her colleague Sergei Makeev discusses the latest developments in Russian work permit and work visa regulations.

In his article 'Long term incentives and Islamic finance' Ross Stubbenhagen explores how equity based long term incentive solutions can be implemented in a Sharia'a compliant manner within the rapidly growing Islamic banking sector.

Finally, in our regular 'International update' we highlight some key dates that UK companies need to be aware of if they currently employ, or plan to employ, migrant workers. We also look at how the Italian tax authorities repealed the tax favourable regime for stock options, and we finish with a quick round up of other topical issues.

I hope you enjoy reading about some of the issues facing our colleagues around the EMEIA group. We are looking forward to working with them more closely in the future. As ever, if you do have any comments, please contact me or one of the team. Our details are on the back page of this newsletter.

Edward Jennings

Editor

The best of times and the worst of times...

It was the best of times, it was the worst of times; it was the age of reason, it was the age of foolishness...

The opening line from A Tale of Two Cities by Charles Dickens neatly summarises the current climate for HR & Reward specialists. The credit crunch has resulted in an unprecedented series of events including the effective part nationalisation of banks in the UK and the \$700 billion bail out in the US. This article summarises some of the key issues facing HR and Reward specialists at the current time.



Edward Jennings is a Senior Manager in Ernst & Young's Performance & Reward team and the Editor of 'High Performance'

Design of incentive and bonus plans

Gordon Brown has stated with regard to the UK banks: "The days of big bonuses are over. One of the conditions of us helping the banks is that we will have to reach an agreement about their executive remuneration". In the US, there is also considerable interest in reforming executive pay. A major overhaul of executive remuneration therefore seems inevitable. How individual and corporate performance is measured and how earnings growth is shared amongst executives, employees, shareholders and stakeholders (including UK taxpayers!) will need to be reconsidered. HR and Reward specialists should play a full part in shaping these discussions.

Retention

The retention of key talent remains as important as ever. Talent management can also be an important weapon in the HR arsenal. Talent management programmes can often be more cost effective than buying talent.

Redeployment

When markets are uncertain, the redeployment of talent can become an issue. This could take the form of reassigning or relocating staff to a more productive role or location (perhaps as part of a talent management or retention strategy) or terminating an overseas secondment e.g., in New York (cost saving exercise).

Redundancies

Many companies and professional firms have traditionally made the mistake of making large scale redundancies at this stage of the cycle to maintain dividends or Partner profits. They have then had to return to the market at a later date and pay a very high premium for employees. It will be interesting to see how companies and firms react to the current market conditions over the next six months and what actions they will take. Recruitment freezes are likely to become widespread.

For professional firms, the downturn in corporate activity is an opportunity to spend time on training and professional development which may have been put to one side during the recent boom. HR will need to be closely involved with these activities.

Employee related litigation

Recent events may lead to an increase in employee related litigation which may take up a considerable amount of HR time.

Current events are unprecedented and dynamic but will result in an increased demand for HR input into the business. This creates a unique opportunity for HR and Reward specialists to shape future policy and strategy. For those who will be blamed for the credit crunch contagion, it may be some time before we know whether they will suffer the same fate as the French aristocrats in A Tale of Two Cities.

Restructurings and lay-offs

The importance of being earnest with Works Councils

On July 22, 2008, Gaz de France (GDF), the public monopoly gas-provider in France, merged with Suez and gave birth to the company 'GDF Suez'. It took more than two years before the merger became a reality, not only because of the French perception that this operation represented 'hidden privatisation' of Gaz de France, but also because of the long and difficult information and consultation process of GDF's French Works Councils (FWC).

Regulatory context

Before deciding any reorganisation, plant closure or layoffs, companies must (i) inform and (ii) consult the FWC on the contemplated project. The information phase requires that the company provide any and all useful information in writing to the FWC in order to allow a full understanding of the contemplated project, including the business justification and HR consequences, if any. The consultation phase requires that the company obtain the FWC opinion on the proposed corporate event, without which it may not be implemented.

In France, the FWC has no veto power, but it has 'nuisance' and 'delay' power: the project cannot go forward without the FWC's clearly expressed opinion (favourable or not).

Many companies fail to carry out phases (i) and (ii). This may lead to the FWC refusing to render any opinion, which can delay the project for months... or years, as illustrated by the GDF example:

The Gaz de France cases before the European and French Works Councils

Information and consultation of the EWC

After protracted and multiple meetings with the EWC since 2006 as to the contemplated merger of GDF and Suez, the EWC still considered that it did not have complete information to render an opinion. It thus sought a court order to postpone the first implementation step: the board of directors meeting. The Court ordered that one additional meeting be held with the EWC and that the board meeting be postponed accordingly. Following an appeal by GDF, the French High Court ('Cour de cassation') confirmed the lower decision on 16 January 2008. Additional information was then provided to the EWC, which rendered its unfavourable opinion on the project in March 2008.

This decision is important given the proposal of the European Commission of 2 July 2008, to increase regulation relating to the European Works Council (revision of Directive 94/55/EC). More than ever, it is critical that the EWC is properly informed and that the information and consultation process is completed, before any steps are taken to implement a restructuring or lay-off project. Failure to do so will delay matters and may lead to court action.

Information and consultation with the FWC

Simultaneously, faced with the FWC's refusal to render an opinion on the contemplated merger, GDF instituted legal proceedings to obtain the authorisation to move forward with its project of amicable merger and absorption of Suez.

On 22 January 2008, the 'Tribunal de Grande Instance' of Paris prohibited GDF from moving forward with the contemplated merger as long as the FWC had not been provided with proper and accurate information allowing its opinion on the project. Once additional information was provided, the FWC rendered its (unfavourable) opinion on 26 May 2008.

Roselyn Sands is a Partner at Ernst & Young Société d'Avocats in Paris. She is an Attorney-at-Law advising on HR aspects of transactions



In any restructuring and/or lay-off project, it is fundamental to anticipate and create a strategy for the FWC information and consultation process both at a national and European level. It is, therefore, critical that sufficient resources are employed to complete phases (i) and (ii) to avoid delays and

further costs. It is also important that all the necessary consultations are built into the project timelines.

For further information, please contact Roselyn at roselyn.sands@ey-avocats.com or + 33 1 55 61 12 99 or your usual Ernst & Young contact.

The Russian labour market

Latest trends and observations

Current market conditions and a decline in foreign investments are having a significant impact on the Russian economy and it is hard to predict what the full impact of the global credit crunch contagion will be. However, the stable development of the Russian economy over recent years, characterised by rapid growth in the oil and gas industry and financial sector, supplemented by the rapid development of other industries including manufacturing, construction and a rejuvenated public sector resulted in 8% GDP growth during the first half of 2008. This gives grounds for cautious optimism that the Russian economy will emerge from the current crisis relatively well placed.

Labour market overview

Following the investment made over recent years by the majority of companies operating in Russia, as well as the rapid revival of the public sector, people are now recognised as being the single most important resource in the Russian economy. Put simply, the demand for suitably qualified individuals outstrips supply.

The shortage of qualified specialists in the Russian labour market is aggravated by the demographic situation (particularly the low birth rates in the 1980s and 1990s) and disruption in the system of professional education. The excessive demand for skilled individuals has resulted in wage inflation. In the last three years, salaries have grown in real terms (ie in excess of the rate of inflation) by 3% to 3.5% on average. This has created a labour market where many employees have the opportunity to dictate personal terms when negotiating with potential employers.

The war for talent has resulted in many organisations in Russia resorting to more

progressive approaches to deal with the classic HR problems of retention and recruitment. Some of these approaches include implementing complex HR policies and practices aimed at removing personnel shortages and mitigating the risk of staff outflow. These measures have inevitably increased HR related costs but arguably save companies money over the medium term. This also means HR budgets are under more scrutiny than ever before as HR costs become an ever greater part of companies' overall expenses. However, current market conditions in the Russian and world markets have forced some companies to implement measures aimed at reducing HR related expenses. Such measures which have been observed in Russia recently include introducing a recruitment 'freeze' and the suspension of ongoing recruitment programmes. Other measures include reducing employee headcounts, 'freezing' salary levels for a certain period of time or delaying HR related programmes (training, education, etc.).

Looking east

New rules for Russian work permits and work visas

In order to simplify the work permit and work visa application processes, the immigration authorities in Moscow and certain other locations have sought to streamline the processes into a 'one stop shop' approach. The idea is that all application forms relating to work permit and work visa invitation applications can be combined and submitted at one place. This approach replaces the previous regime which involved submitting separate work permit and work visa forms with different government offices. However, the 'one stop shop' option is only currently available in Moscow for members of major business associations. Employees of other

companies still need to undergo separate work permit and work visa processes.

Whilst a 'one stop shop' approach is already live, it is important to remember that there is still a preceding stage to this process under the Russian law. Companies are required to submit a notification of their vacancies to the Russian employment authorities, who search for suitably qualified candidates in their database on the Russian labour market. If a suitable candidate is found, they are sent to the company for interview within 30 days from the date of submission of a notification of a vacancy. If the post remains open for one month, application forms can be submitted

to the 'one stop shop' application process.

Another important development is that representative offices and branches of foreign legal entities can now register with the Russian immigration authorities for the purpose of work visa invitations. Historically, employees of representative offices and branches of foreign legal entities were allowed to apply for a work visa through the State Registration of Chamber or the Chamber of Commerce and Industry based only on a personal accreditation card. The direct registration for visa support purposes envisages provision of either an individual work permit or corporate work permit together

Ksenia Kamenskaya is a Manager in Ernst & Young's Performance and Reward team in Moscow.



The majority of companies in Russia are currently taking a 'wait and see' approach and are waiting for market developments before they implement any HR related changes.

Russian salary survey

According to the General Industry Salary Survey conducted by Ernst & Young Russia (Ernst & Young Survey) salaries have grown on average by 15% during the 12 months to 30 June 2008.

One of the most interesting facts to emerge from the Ernst & Young Survey is that the proportion of fixed and variable pay in employees' compensation packages has changed over recent times. Many companies in Russia have introduced performance based remuneration programmes for their employees. In addition, a greater part of employees' cash remuneration has become dependant on the achievement of performance conditions. The Ernst & Young Survey shows that, on average, approximately 40% of cash remuneration for top managers

is performance-based variable pay. For certain industries, the weight of variable pay as a proportion of total compensation may approach or even exceed 100% for top managers. For lower positions the ratio of variable pay tends to be smaller (21% to 24% of total cash remuneration for senior and middle level jobs and 20% for lower level jobs). The general trend is for such performance related pay to be more widespread. Under current market conditions, it is likely that many performance conditions may not be met, which will result in reduced cash payouts under performance-based incentive plans.

The current market conditions are also influencing the number of equity based long-term incentive plans (LTIPs) which are being introduced in Russia. As there is a shortage of experienced top managers in the Russian market, the level of interest in LTIPs has grown significantly in recent years as LTIPs are seen as a valuable recruitment and retention tool. According to the Ernst & Young Survey, 24% of the participating companies already use LTIPs as an incentive tool (either a worldwide plan tailored to

the Russian market or Russian LTIPs) and 43% of participants reported an intention to implement LTIPs in the near future. However, current market conditions make equity-based incentive programmes less attractive than cash plans. We therefore expect many companies to suspend existing plans to introduce LTIPs until market conditions have improved.

The Russian economy will continue to be influenced by world markets and there are signs already that recent global events have influenced HR decisions made by some Russian companies. However, the strength of the Russian economy coupled with the shortage of talent in Russia generally means that HR issues will continue to be a major factor for companies operating in Russia.

The Ernst & Young Survey is carried out annually and covers over 300 general industry positions and some specific industry jobs from all over Russia. Copies cost US\$ 2,600 and are available by contacting the **Ernst & Young Russia Survey Team at +7 495 755 98 43 or Salary.Survey@ru.ey.com**

with a copy of a document confirming submission of documents for applying for an individual work permit. Also, in some Russian regions representative offices and branches of foreign legal entities are now required to register directly with the immigration authorities in order to apply for work visa invitations independently. This requires employees getting work permits first to apply for work visas.

Direct registration for visa support purposes assumes only applications for a work visa invitation and, therefore, this process cannot be used for business visitors. This means that for inviting business visitors, foreign companies will

need to involve their business partners (Russian legal entities) to sponsor business visa invitations.

Whilst the immigration authorities are trying to simplify the immigration system, it can still be quite burdensome. However, the positive intent of the authorities gives at least some hope that this and other potential changes, once properly implemented, will finally make Russian immigration procedures less burdensome.

Sergei Makeev is a Senior Manager in Ernst & Young's Moscow office, specialising in global mobility.



Long term incentives and Islamic finance

Globally, there are approximately 350 Islamic financial institutions managing assets estimated at US\$ 500 billion.

Britain, and London in particular, is rapidly emerging as the major centre for Islamic finance outside the Middle East and Malaysia. This is due in part to its already sophisticated financial system as well as government efforts to level the playing field between Islamic and conventional products in terms of regulation and taxation. London also provides an ideal base to expand into Europe.

At the time of writing there were six wholly Islamic institutions already operating in the UK. In addition to these stand alone organisations, a number of conventional banks also operate Islamic subsidiaries.

These institutions provide a wide range of Sharia'a compliant products ranging from retail banking to wholesale investment banking and insurance. The most widely reported deal in this sector was the £522 million buy out of classic British sports car manufacturer Aston Martin by Adeem Investment and Investment Dar¹; the deal being lead by West LB.

As well as having a population of approximately two million Muslims, London's dominant position in the capital markets means that it is well placed to be the ideal gateway to channel excess liquidity from the Gulf region into Western markets.

Ernst & Young's approach to this market is to bring together a central core of Islamic specialists with subject matter experts in our traditional disciplines. This approach allows us to deliver our full range of services whilst understanding the very different challenges faced by Islamic institutions. This is the approach which has been taken to delivering our Performance & Reward services in this market.

Designing equity or cash-based long term incentives for Sharia'a compliant organisations which are equivalent to those found in the conventional banking sector (to facilitate recruitment or as a retention tool, for example), presents a number of challenges. In particular, many of the most common arrangements, such as share options, are prohibited due to the inherent uncertainty in respect of the closing of the transaction or the payment or receipt of interest as part of the arrangement.

The Performance & Reward team has developed an equity-based long term incentive solution which is both flexible enough to replicate the economic return on a nil-cost or market-value share option and had been approved by recognised Islamic scholars as Sharia'a compliant. In addition, it provides a beneficial tax treatment for the employee and a significant National Insurance Contributions saving for the employing company when compared to a traditional share option.

Rather than give the employee the right to acquire company shares in the future, this arrangement allows them to acquire an interest in those shares and bear the risks and reward of that investment on similar terms to third party investors. This approach fits well with the key Islamic principle that all parties to a venture should bear an equal risk if that venture fails. This is in stark contrast to an option arrangement which provides a one way bet for the employee.

As Sharia'a organisations become larger and begin to extend equity incentives to employees generally, we will encourage the UK Government to take steps to allow HMRC approved, all employee, shares plans such as the Save As You Earn scheme and Share Incentive Plan to be adapted for implementation in the Sharia'a compliant environment whilst retaining their approved status.



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¹ Source: PrivateEquityOnline, 7 February 2008

International update

Constant changes in the legal, regulatory and tax environments around the world mean that it is imperative that everyone working in global share plans remains vigilant. All members of the Ernst & Young global network contribute to the maintenance of the Global Incentive Compensation Reporter and our own internal databases. Cat Coles looks at some of the most recent changes.

United Kingdom

Are we ready? Some of the key dates that companies need to be aware of if they currently employ, or plan to employ, migrant workers

As mentioned in the previous edition of High Performance, 2008 heralds some of the biggest changes to UK immigration rules for 40 years. The newly designed Points Based System (PBS) introduces a scoring arrangement wherein migrant workers are rewarded points based on such attributes as academic qualifications and age... or lack thereof, with under 30s coming out on top. The greater number of points afforded, the greater the likelihood one has of being allowed to settle permanently in the UK. Based on accumulated points, workers are assigned a rung in a five tier hierarchy.

There are substantial reporting and compliance duties placed on employers under the PBS, some of which are completely new. Companies should bear in mind that their existing systems and processes may not be sufficient and may require modifying.

For example, 'Tier 2' which replaces the current Work Permit scheme, is scheduled to go live this November. Companies wishing to employ or transfer Tier 2 migrant workers to the UK have been required to make an application to become a sponsor with the UK Border Agency (UKBA).

Earlier this year, the UKBA also introduced new legislation to prevent illegal working: companies are now required to carry out an annual check on the working rights of all time-bound migrant workers. Time-bound migrant workers will include work permit holders, HSMP/Tier 2 visa holders, students, holders of 'dependent' visas, UK ancestry visa holders or those holding any other type of time-bound visa. The

measure applies to all employees engaged since 29 February 2008 and employers must act to avoid, amongst other sanctions, civil penalties of up to £10,000 per worker. In light of these measures, companies might consider implementing a process for the annual checks, the first one being due by 28 February 2009.

Italy

The Italian tax authorities repeal the favourable tax regime for stock options from 25 June 2008

Rules introduced in the 2006 Italian Tax Reform meant qualifying stock options could be subject to tax at a flat rate of 12.5% on exercise with no social security contributions payable.

Just two years later, in a move likely to disappoint employee option holders, the Government has decreed that options are instead to be taxed at exercise at progressive income tax rates, which can be as high as 45%. The difference between the value of the shares at exercise and the exercise price paid by the employee is subject to taxation as employment income although, as a slight concession, no social taxes will be due.

The new rules came into force on 21 August 2008 but are applicable to stock option income derived from exercises made after 25 June 2008, regardless of the grant and vesting date.

No one likes to be the bearer of potentially bad news but companies should consider advising their employees that the favourable 12.5% flat rate for the taxation of qualifying stock options is no longer available and that higher marginal income tax rates may now apply.

Quick update

- ▶ Latvia recently removed the ceiling for income subject to social security contributions and introduced higher employer penalties.
- ▶ A new favourable impatriate income tax regime has been implemented in France and is applicable to assignments in France commencing on or after 1 January 2008.
- ▶ The Australian Government recently announced significant changes to temporary residents' superannuation, allowing individuals to reclaim superannuation contributions made by their employers after their permanent departure from Australia.
- ▶ The United States has a number of new social security totalisation agreements due to come into force within the next two years. These agreements may eliminate any dual social security liabilities between the US and the other countries. This will potentially be beneficial for globally mobile employees and will provide employers with opportunities to minimise ongoing employment costs. We will continue to monitor the changes and will be providing you with regular updates in this section.



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Forthcoming events

'Accounting for income taxes – the new accounting standard' – 4 November 2008

This seminar will focus on a consideration of the potential impact of the revised accounting standard for income taxes on the financial statements and how businesses should understand, interpret and prepare for these changes.

For more information on this event please contact **Vicki Haley, vhaley@uk.ey.com**

'Inbound tax forum' – 10 November 2008

This session will discuss developments in tax accounting together with how groups should plan their year-end procedures to ensure the audit process is less onerous and common pitfalls are avoided when providing for current and deferred taxes. The session will also cover how future accounting standards may develop and the associated impact on tax.

The second topic will focus on the status of various proposed legislative changes including the taxation of foreign profits and disguised interest. Depending on the date of the Pre-Budget Report, this will be covered as well.

For more information on this event please contact **Lee Pine, lpine@uk.ey.com**

Key dates

January 2009

Next issue of 'High Performance'

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