Work on your winning strategy

It's time for variable pay to deliver the best returns

July 2010

In a challenging business environment, companies must make the right call on strategy and performance if they are to take full advantage of their variable pay programs.

> Lip service to strategy will no longer be enough. Companies that clearly define performance will be the ones that survive.

A new perspective on bonuses

Bonuses are back. Thirty nine percent of companies have or plan to increase the proportion of variable pay in employees' pay packets, and 26 per cent are bringing more of their employees into their variable pay schemes, according to our latest global research study.

But it's not business as usual. Our research also found that the board and senior management are taking a greater role in decision making on variable pay in over half of the companies we surveyed, and nearly two thirds were changing their variable pay programs to better align with their business strategy. Bonuses may be back, but they look different – strongly tied to the bottom line, with more challenging targets and a greater focus on return on investment.

While these trends are largely consistent across sectors and countries, the context in which they are playing out varies significantly. Companies in emerging economies are being challenged to retain employees in competitive talent markets, and are focused on building talent management practices that can match up to their counterparts in the developed world. In contrast, those counterparts are looking for ways to drive performance while reducing cost, with resulting risks to engagement and long-term sustainability.

Our research reinforces the need to take a strategic approach to variable pay in order to remain competitive in a tough market. Lip service to strategy will no longer be enough – the companies that succeed in clearly defining their desired performance and pay accordingly will be the ones that survive.

> Rather than taking a 'me too' approach, companies are at last aligning reward and company strategy.

Bonuses on the rise, but tied to performance

Our research found that 22 per cent of companies had already increased the proportion of variable pay, and 17 per cent said they planned to do so in the future. Fourteen per cent of companies questioned had widened the eligibility criteria for short-term incentives and a further 12 per cent planned to follow suit.

Over 60 per cent of companies questioned told us that their main reason for changing their variable pay policy was to align reward more closely with business strategy. Forty per cent told us that a key driver was to improve performance.

And it's coming from the very top

Variable pay has become a board-level issue. Fifty five per cent of companies reported the board was more involved in variable pay decision making now than they were two years ago. This reflects the need to address the challenging economic situation. But there are also signs that rather than introducing a 'me too' variable pay policy, companies are at last taking a strategic approach, aligning reward and company strategy and strengthening the links between reward and performance.

The volatility in the global economy over the past two years has led companies to re-examine the measures they use to assess performance, to reduce the risk of disproportionate or undeserved bonuses. There is a new discipline around the subject, with companies conscious that variable pay must be closely aligned to corporate strategy and communicated well if it is to be effective. But it is also apparent that companies continue to be largely unconcerned by the risks involved with poorly-designed or badly implemented schemes. Only five per cent of respondents mentioned risk as a driver of change.

What are the most important drivers of change to your variable pay program?

Better alignment with business strategy	61%
Improve company or team performance	40%
Create better alignment or line of sight between corporate and individual performance	36%
Ensure market competitiveness	29%
Reinforce specific business priorities	25%
Improve individual performance	25%
Improve employee engagement	21%
Ensure retention	15%
Better balance of fixed and variable costs	11%
Ease with which the program can be communicated and understood	7%
Satisfy external stakeholders demands (investors, media, community)	6%
Comply with regulations or governance requirements	6%
Reduce risk	5%
Other	3%

Our research

Responding to strong interest in variable pay from our clients, we questioned over 1,300 companies worldwide on their variable pay policies and their plans for variable pay strategy in the future. Using these responses and detailed data from our PayNet databases, we are able to identify key trends and current practices in variable pay. We also looked at the level of variable pay that companies are using to drive performance through variable pay schemes worldwide, and what companies planned to pay in bonuses to their managers against what they actually paid. More information on the research methodology can be found in *Appendix 1 – About the research*.

Are companies missing the point?

While the focus on strategy is encouraging, there are indications that many companies may not be getting it right.

Risk: Overall, few companies are concerned about risk and compliance. It is possible that companies are addressing risk through the alignment with business strategy. We would welcome this to some extent as there is a real danger that an over-reaction to risk could stifle innovative reward strategy. However, we remain concerned that many companies have yet to come to terms with the level of risk that they carry in a variable pay program – financial, operational and reputational risk – and have simply put the question aside.

Implementation: A common problem is that program designs link reward to strategy, but is poorly implemented. Variable pay will not drive performance if the line of sight between employee actions and company strategy are not clearly understood by the program participants. Unclear or insufficient communication on strategy or program design, a lack of buy-in or performance management skills from line managers, or overly complex measures can all contribute to an ineffective program.

Short vs long-term: The focus on financial metrics indicates that many companies have still failed to grasp the link between sustainable performance and non-financial measures of performance. A narrow focus on financial return has the potential to skew behavior towards 'revenue/sales/cost savings by whatever means necessary'. It also tends to disengage the majority of employees, who are motivated by more than financial success and who want to be part of an enterprise or goal that they can believe in.

The best variable pay programs:

- reflect the company's business model and work culture
- take into account the impact different employee groups have on performance
- are tailored to employee preferences and demographic profiles
- are fully integrated with the overall reward program
- are modelled against projected profitability and are hedged against potential volatility.

Performance = the bottom line

Our research showed a marked change in the approach of companies to the measures used in variable pay. Almost half of companies said they had already reviewed their performance metrics and a further 25 per cent said they planned to review their metrics in the near future.

One of the most significant legacies of the economic downturn has been a trend away from 'soft' metrics, such as employee satisfaction or turnover, to hard financial measures. Fifty one per cent of companies questioned said they were using more financial metrics in performance-based pay than before. In our experience those financial measures are also shifting from revenue growth to profitability. Operational metrics, driving specific actions or process improvements, have also grown in popularity with 23 per cent increasing the emphasis on operational metrics in the past two years.

A concern is that companies may create the impression that only performance that directly drives financial returns will be rewarded. This presents problems for employee activities that are not directly related to the bottom line, such as support and non-sales functions. Perhaps more importantly, a focus on financial metrics may also encourage behaviors focused on short-term financial gain, without consideration for social, environmental and brand issues – one of the factors that drove the credit crunch in the first place.

A successful reward strategy that encourages the most valuable performance must be underpinned by the right performance measures in the right combination. Our studies of *Fortune*'s Most Admired Companies clearly shows that while peer companies apply performance metrics that are focused on operational excellence, profits or revenue, the most admired go further by adding measures around long-term thinking, teamwork, building human capital and customer loyalty. They recognize the need to find a better balance between short and long-term metrics, between corporate and individual performance, and between financial, operational, customer and human capital metrics.

Successful variable pay programs must balance competing stimuli and risks. If a bonus scheme fails to pay out in a bad year, employees can become disengaged at a time when the company needs them most. Conversely, a bonus scheme that pays out regardless of corporate performance will not drive discretionary effort. The challenge for companies is therefore not only identifying the right measure, but the right targets: should the target be absolute or relative? Should it be in line with this year's budget or with last year's performance? A further consideration is the level at which performance targets are set: should average performance be awarded? Or only excellent performance?

There is no one correct answer: the best programs are those that reflect the company's particular business model and culture, rather than those which are copied from 'best practice' or industry standards.

The link to engagement

Just under half (47 per cent) of companies questioned told us that they plan to increase or already have increased performance thresholds, and 38 per cent are introducing a performance hurdle below which bonuses will not be paid. This is to be expected, given the renewed focus on performance and that less cash is available for reward budgets. It is possible that companies are funding 'virtual pay rises' with variable pay schemes, recognizing that they will be able to afford to pay out if performance improves.

However, raising performance thresholds could have a serious impact on employee engagement. This is a particular risk in the current economic environment, since many employees have seen limited or no pay rises and bonus payments over the past two years, and have also seen the value of their pensions fall. If the variable portion of their pay is made too difficult to earn, there is a danger that they will disengage altogether.

Companies cannot afford to disregard the link between variable pay and employee engagement, particularly in an environment where many are already asking their employees to do more for less. Employees will no longer be happy 'just to have a job' and companies need to find effective ways to prevent loss of talent as market conditions improve. Our Hay Group Insight research has shown that companies with the most engaged employees report revenue growth at a rate two-and-a-half times greater than their competitors with the lowest level of engagement. Furthermore, companies who effectively combine employee engagement and enablement (empowering employees with the tools and processes to 'go the extra mile') report significantly improved revenue growth, staff retention and employee performance.

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Making it real

In recent years, companies have tended to focus more closely on the mechanics of variable pay, such as performance metrics and goals, pay mix and eligibility criteria. Our research suggests, however, that companies are becoming much more focused on evaluating and measuring the effectiveness of their variable pay policy. Just over half of companies (55 per cent) told us that they had put or were putting processes in place to evaluate the effectiveness of variable pay. We see this trend continuing strongly in the future, as more CEOs focus on the return on investment from their reward spend.

Increased attention is also being paid to effective communication of reward programs, with almost 60 per cent of companies changing the way they communicate to employees. But the majority are still falling short. Just over half (58 per cent) of companies questioned believed that their variable pay policy was well understood by their employees, and only 34 per cent felt that their variable pay policy was communicated effectively.

Companies are beginning to recognize that line managers play a key role in communicating variable pay schemes, but a third said their line managers were not effective in doing so, and almost half told us that their employees do not understand what 'performance' looks like. A variable pay strategy will not drive performance if the objectives and link to company strategy are not clear. The message must flow from the very top, with strong leaders who can set out a coherent strategy and help all employees understand they have a role to play in realizing it. Leaders must also rise to the challenge of demonstrating and communicating externally the link between reward strategy and company performance.

The international perspective

Ultimately, the effectiveness of a variable pay strategy is dependent on its alignment to the company and market context. Our country-to-country analysis of variable pay at managerial level revealed a higher proportion of variable pay – and better pay-out rates – in many emerging markets (see *Global bonus parctices* at the end of this report).

The low pay-out rates in developed markets, such as the UK and US, are largely a reflection of the greater impact the recession had in these markets. The data records bonuses paid out in 2009, which themselves would have been strongly affected by corporate performance in 2008 – when the worst of the recession hit. The UK and US were among the first to be hit by the recession and were quick to reduce payouts.

The higher proportion of variable pay is, we believe, a reflection of the level taken as the manager level sample. 'Manager' level equates to a mid-management position in developed countries, but often is senior management or executive level in smaller markets. This means variable pay is more likely to form a larger proportion of their pay packets. We would expect to see a higher proportion of variable pay in, say, the US and UK at executive level – where there is often no equivalent position in smaller economies. But our experience also points to other, less straightforward explanations – and it is these factors that companies operating in these markets need to be aware of.

The performance management link

Markets such as the UK and the US have a culture where bonus differentials between average and excellent performers are commonplace, and indeed expected. However, it is considered unacceptable in some cultures to tell employees that they are performing poorly, or even that they are not top performers. This means that in some regions – most notably the Middle East and India – employees will tend to receive what they expect to receive, rather than bonuses being genuinely related to their performance. We regularly see performance assessment figures that show 80 or 90 per cent of employees being rated as 'very high' or 'excellent' performers.

"Variable pay is a developing practice in the Middle East and those companies that do set performance goals for individual employees tend to keep the targets low. While there is an increasing trend for companies to differentiate pay by performance, there is still some way to go in aligning reward and business strategy, and in assessing the effectiveness of variable pay."

Hay Group Middle East

> "The Chinese market is very focused on retaining high performers and our research shows companies in China placing more emphasis on improving retention and engagement than the global norm. This also drives high levels of bonus payout. However, many companies fail to really differentiate bonus payouts to truly reward high performance, which in itself has an impact on engagement and retention – and so these concerns can be counterproductive."
>
> Hay Group China

The retention battle

Rapidly growing and highly mobile markets such as India and China are reluctant to risk losing key workers by failing to pay out a bonus, even if performance targets are not met. Wage inflation in these economies remains high and can even overtake the annual pay review cycle. As a result bonus payments are often used as a retention tool rather than to reward performance.

A developing practice

Paying for performance is a new concept in many of these economies, and one that often sits uncomfortably with existing cultural norms and market practices. But at the same time there is a powerful shift towards adopting international practices, including variable pay. In China, for example, a manager who received an annual bonus equivalent to 1.1 months salary in 2005 would now expect to receive closer to 2.5 months salary in bonus.

Companies, both local and multinational, need to be aware of these tensions and manage them carefully. Perhaps even more than their counterparts in developed economies, they need to focus on establishing links between corporate strategy and variable pay that inspire their employees and fit their particular cultural and market context. Line manager's skills in performance management are also critical. Leaders need to encourage and support managers to differentiate high performance and tools such as calibration and forced distribution should be considered.

For those responsible for reward in multinational companies, these differences will have to balance local and global demands, addressing contextual disparities between emerging markets and more developed countries.

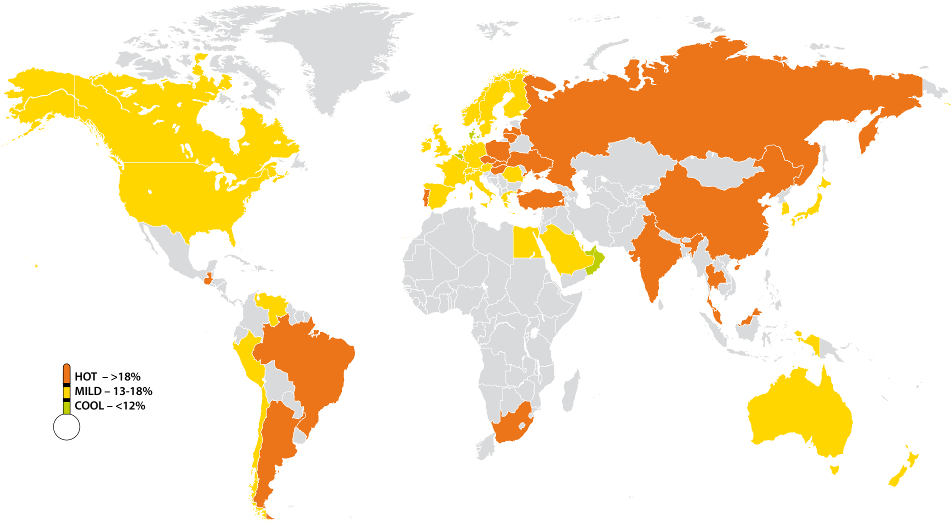
Steps to effective variable pay

- Understand your strategy – what does the company want to achieve, and how?
- Define performance and establish line of sight between metrics and company strategy
- Communicate clearly, using the power of effective leadership and line management buy-in
- Monitor and review to ensure the program is driving the performance you want

Global bonus practices

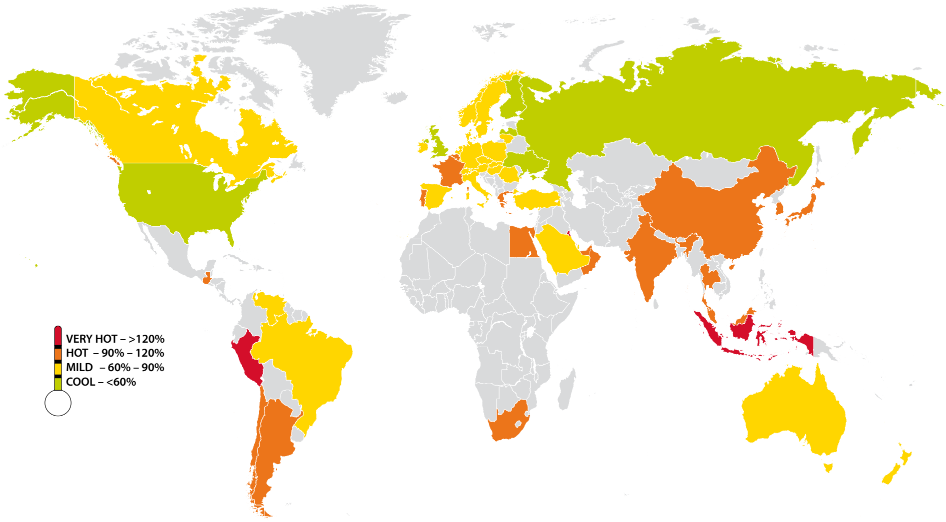
Target variable pay as % of base pay*

Hot	Luxemburg
Argentina	Malaysia
China	Netherlands
Czech Republic	New Zealand
Hungary	Norway
India	Peru
Latvia	Poland
Russian Federation	Portugal
Slovakia	Qatar
Turkey	Romania
Mild	Saudi Arabia
Australia	Singapore
Austria	South Africa
Brazil	Spain
Canada	Sweden
Chile	Switzerland
Egypt	Thailand
Finland	Ukraine
France	United Kingdom
Germany	USA
Greece	Venezuela
Guatemala	**Cool**
Hong Kong	Bahrain
Indonesia	Belgium
Ireland	Denmark
Italy	Kuwait
Japan	Oman
Korea	United Arab Emirates
Lithuania	



Actual pay-out as % of target*

Very hot	Czech Republic
Indonesia	Denmark
Kuwait	Germany
Peru	Hungary
Hot	Ireland
Argentina	Italy
Bahrain	Lithuania
Chile	Luxemburg
China	Netherlands
Egypt	New Zealand
France	Norway
Greece	Poland
Guatemala	Portugal
Hong Kong	Qatar
India	Romania
Japan	Saudi Arabia
Korea	Slovakia
Malaysia	Spain
Oman	Sweden
Singapore	Switzerland
South Africa	Turkey
Thailand	Venezuela
United Arab Emirates	**Cool**
Mild	Finland
Australia	Latvia
Austria	Russian Federation
Belgium	Ukraine
Brazil	United Kingdom
Canada	USA



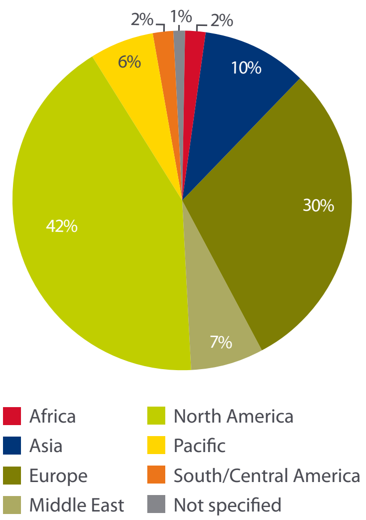
*Based on target bonuses for management level employees set for 2008 and paid out in 2009

Appendix 1 – About the research

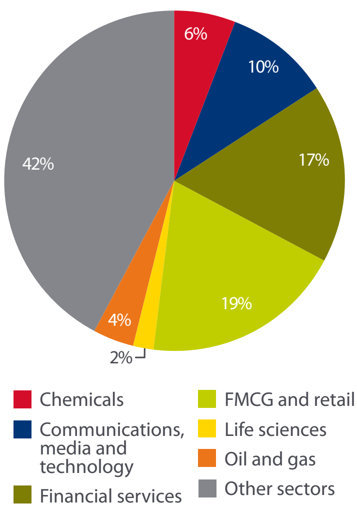
Responding to strong interest in variable pay from our clients, this research was conducted to identify key trends and current practices in variable pay.

In May 2010, we surveyed over 1,300 companies from across 80 countries on their variable pay policies and their plans for variable pay strategy in the future.

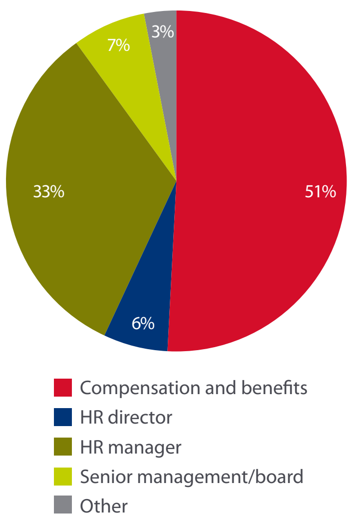
Responses by geopgraphy



Responses by sector



Responses by role



We also used detailed data from our Hay Group PayNet databases to analyze country-to-country the amounts (as a percentage of base salary) companies planned to pay in bonuses to their managers against what they actually paid.

PayNet, Hay Group's online reward information database, provides instant access to the most timely, reliable and comprehensive reward and benefits data covering 12 million incumbents, more than 14,500 organizations and all major industries.

The PayNet data used relates to time period March 2009 - February 2010 and is based on the Hay Group standard middle management level employee, which is generally equivalent to a middle- to senior-level manager in a department or function of a large multinational company. In a smaller economy, it is more likely to be equivalent to be a department or functional head.

About Hay Group

Hay Group is a global management consulting firm that works with leaders to transform strategy into reality. We develop talent, organize people to be more effective and motivate them to perform at their best. Our focus is on making change happen and helping people and organizations realize their potential. Visit **www.haygroup.com**