In the wake of the financial crisis, return on investment, cost control, risk and engagement have emerged as the key concerns driving change in reward. Our study examines how organizations – from the board down – are looking to their reward programs to deliver the performance they need.
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“Across all sectors and regions, organizations are struggling to rebuild profitability following the recession. With revenue growth hard to come by, they are focusing on cost containment and performance improvement as the paths to profit growth.”
Across all sectors and regions, organizations are struggling to re-build profitability following the recession. With revenue growth hard to come by, they are focusing on cost containment and performance improvement as the paths to profit growth. This requires them to balance four, often conflicting, challenges: cost containment, performance improvement, talent engagement and risk management.

In particular, the tension between cost containment and talent engagement was a very strong theme to come out the research. Organizations are very concerned about retention and motivation, particularly for top performers, high potentials and those with scarce skills. However, the option of paying more for retention or performance is often no longer available and companies are focusing more on intangible rewards (such as motivational leadership, challenging work and career development) to boost engagement.
Trends in reward

The research found some clear themes in how companies are using reward to tackle these challenges.

**Making pay for performance a reality**: the study shows a much greater focus on creating a culture of performance through aligning rewards to the performance metrics that drive profit and revenue growth.

**Differentiating and rewarding ‘mission critical’ roles**: companies are channeling the limited rewards available in a far more focused way to those employees most vital to the future of the company: the top performers, high potentials, and those with scarce skills. They are also taking a total reward approach to engaging that key talent by offering clear career paths, global mobility and targeted development programs as well as higher monetary rewards.

**Increasing variable pay**: companies are increasingly awarding a greater share of total rewards to variable pay to increase focus on critical goals, and to reduce the vulnerability of companies to high fixed reward costs. However, they are also re-examining the measures they use to assess performance, to reduce the risk of disproportionate or undeserved bonuses and to reflect a broader understanding of performance that includes social responsibility and brand. The assessment of risks inherent in bonus schemes is also becoming more frequent.

**Centralization**: reward policies and programs are increasingly being centralized. This is being driven by a desire for consistency of focus on key objectives, and to reduce costs and risk. Companies are striving to find an ideal balance between global consistency and local flexibility, to best manage the impact of local markets, culture, taxes and regulations.

**Market benchmarking**: the study showed a surprisingly strong focus on benchmarking, given the relatively quiet talent markets. This is driven by a desire to ensure that top talent is paid competitively against the market, and that organizations are not paying too much in other areas.

“Reward is now a top management issue, with the CEO and the board getting closely involved.”
Reward is on the board agenda

Reward is no longer the province of compensation and benefits experts. Representing anywhere up to 70 per cent of a company’s total costs, reward is now a top management issue, with the CEO and the board getting closely involved. The study shows that reward is now more than ever under the microscope, with CEOs asking:

- What performance are we getting in return for what we pay?
- What is the effectiveness of all the costs allocated to reward?
- What is the return on investment?

Alongside this, the role of the compensation committee is undergoing radical changes, with a much greater remit to oversee all reward programs and understand their impact on costs and risk.

This is in part being driven by the growing impact of regulation and taxation. The concern is that this is deviating scarce management time to ensuring compliance, rather than formulating the best reward strategies for their companies. It can lead to outright distortions in reward structures – for example to ensure tax effectiveness – without consideration of whether those structures work to drive sustainable performance. Similarly, a heavy focus on compliance also risks stifling innovation as the board becomes wary of attracting adverse attention with non-conformist reward structures. Developing and delivering reward programs that are cost effective, drive performance improvement, build talent and avoid undue risks: these are the challenges ahead. Getting reward right is mission critical for all organizations.

Top of mind

Throughout the responses to our research, common threads emerged as to what was top of mind for respondents. Summarised below are the top three themes for each topic covered.

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The new business imperative: do more with less

All the respondents to our survey were clear that the recession will leave a lasting legacy: there will be no return to ‘business as usual’. Those organizations that survived the immediate challenges of a deep and wide-reaching downturn have emerged to a changed landscape. The world is a tougher, more cost-conscious, performance-oriented place.

The crisis as a change accelerator

On a fundamental level, the recession has accelerated the pace of existing macroeconomic changes. The shift in emphasis towards emerging markets has become more pronounced as markets such as Brazil, India and China have continued to grow and have proved resilient against the long-term effects of the financial crisis. The speed of change has increased across all sectors as organizations innovate to protect their position in the market and use technology to find new and better opportunities. Regulation and scrutiny of corporate activity, decision-making and crucially, reward, has increased.

Organizations will have to adapt quickly if they are to thrive in this uncompromising environment. No-one has the luxury of time or money to throw at the issues they face.
The recession has intensified the pace of globalization as organizations seek out markets where they see the opportunity to achieve real growth. Many organizations in both developed and developing countries are looking to expand internationally, to gain access to new buyers and spread the risks of operating in just one market.

**Costs under the microscope**

Companies in every region have been affected by the fall in demand. Many niche players have disappeared in a flurry of consolidation, and competition has increased as organizations fight to defend or extend their market share. Companies are focusing heavily on customer retention and maintaining client relationships while they wait for market conditions to improve.

As a result, cost containment is a major issue for many organizations, in all regions and sectors. Most have already cut employment costs as much as they can through redundancies, restructuring, pay freezes and restrictions to internal investments. The focus for most has now turned to the centralization and rationalization of business and management processes. In stagnant or slow-growth markets, cost management continues to be critical to survival; but even those organizations who continue to grow are taking the opportunity to reassess their cost base, optimize their management processes and put their operations on a more sustainable course for the future.

Companies in high-growth developing markets are working even harder to bring themselves up to international standards – many see the slowdown as a welcome opportunity to gain some breathing space from the intense pace of change.

Organizations are emerging from the recession leaner and intent on concentrating on those activities that bring the greatest returns to the organization. Difficult choices are being made; the money that is available has to be earned through performance and allocated to those areas (and people) most critical to business success. While the focus remains on the bottom line, from now on increased efficiency will be a core driver of profit growth.

“We are meeting these challenges through changes in our organizational structure, improved processes, increased productivity, and increased cost control.”

Financial services company | Europe

“We are looking at sustainability and affordability carefully. We’re scrutinizing all activities to see whether or not they are critical to our business.”

Large multinational energy organization
“As well as looking at our organization structure, we are developing business strategies and plans to identify where we want to invest for future growth, to maximize benefits in geographies where we are the strongest.”

**Performance is the new mantra**

Performance is the fundamental focus of most organizations. In a boom market, many organizations were prepared to achieve growth at the expense of the bottom line in anticipation of seeing future returns from increased market share. In contrast, organizations now want to demonstrate a verifiable return on investment from any activity – and with employment costs representing anything up to 70 per cent of an organization’s cost base, this includes reward.

The dominant theme from most respondents is ‘doing more with less’. As well as addressing organizational structures and increasing the efficiency of systems and processes, there is a very strong focus on the alignment of team and individual performance to corporate goals. Leadership has also come under the spotlight as organizations ensure that their management has the strength and skills to lead the organization out of the recession.

Leading organizations, however, are already turning their attention to the future. For them, the focus on execution has already begun to shift to building a strategy that will position them for growth. While short-term considerations may have come to the fore during the recession, the best leaders continue to balance short and long-term considerations.

Recognizing that an excessive focus on short-term shareholder return was one of the root causes of the financial crisis, the best leaders are keeping one eye on long-term strategy and further, on the role their organization plays in society. Performance is being redefined, and with it reward.

**Risk is on everyone’s minds**

An air of conservatism pervades the study. Organizations – even those in high-growth mode – are painfully aware that the stability of the market cannot be assumed. Increased regulation and public scrutiny, especially around reward, are also putting risk on the agenda for the board and senior management. This is driving demand within organizations for more information and assurance that decisions have been taken in full understanding of the inherent risks.

“HR is no longer seen as an analytical function that shows ‘how things are’, but is involved in many more management decisions.”

**Polska Telefonia Cyfrowa | Poland**
“Return on investment has become an important metric and one that needs to be better used and tracked. There has been a marked shift from ‘pay and treat people well’ to really getting a return on HR investment.”

S&P 500 manufacturing company | US
The talent management challenge

In this tough market, a talented, engaged and motivated workforce is even more critical to success. The employment relationship has been redefined. The old loyalty-for-security bargain has been cast aside and the connection between individuals and organizations has become more tenuous. This demands a different approach to talent management.

Targeting top talent

The emphasis on retaining and rewarding high performers emerged as one of the strongest themes of the study. Organizations of all sizes in almost every sector cited the recruitment and retention of key talent, along with the development of good internal candidates, as a dominant strategy.

The relentless focus on cost-cutting during the recession has resulted in many organizations stripping out poorer performers. Organizations have emerged with a leaner workforce but with a correspondingly greater reliance on their best people, many of whom have taken on wider roles as a result of restructuring and often for limited or no incremental increase in compensation. Retaining these people is a key priority.

At the same time, the market for those key roles and talented individuals has scarcely abated. Many organizations in emerging economies are looking for future leaders who are able to work within the existing organization and cultural background, but also work effectively in a global context. Increasingly they are competing for those same talented individuals with other global organizations looking to expand into their market.

An urgent need for more stringent succession planning was raised by many respondents to the survey. With the baby boomer generation reaching retirement age, identifying and preparing the best leaders for the future is a real concern for many organizations. The challenge for many, though, lies in meeting the different demands of a younger generation of workers. Generation Y expects a patchwork career, does not routinely demonstrate loyalty to a single employer, and expects to be in charge of their own career path. More and more employees are looking for an environment where they feel they are contributing in a positive way to something larger than themselves.

Don’t forget to manage the middle

A word of caution has to be offered about an over-reliance on high performers to deliver business results. The majority of people who work in most organizations fall into neither the poor performer nor the star category, but are good, competent, average performers. It is shifting performance in this middle category that will really make a difference to surviving the present recession and performing in the upturn. Organizations should not take their eye off the ball on efforts to keep this critical set of staff motivated, engaged and adequately rewarded for the positive contribution they make.
Sector focus: Retail – filling the boomer void

Hit first and hardest by the economic downturn as consumers immediately cut back on discretionary spending, retail has been at the bleeding edge of the recession. As a result, retailers have aggressively cut costs, inventory and staffing levels in line with poor expected sales. As prospects begin to improve once more, the focus for retailers is to identify and differentiate those employees who make a major contribution to top line sales.

For the past two years the question of retention in the sector has barely raised its head. But when demand bounces back – whenever that may be – the pressure to recruit talented sales people and managers, particularly those with global experience, will be enormous. The pressing issue for the sector is where will it find that key talent.

Until the 1990s the sector had a strong tradition of developing talent internally, spicing up the mix with a small number of external hires. The increased globalization of business, the boom in ecommerce and the enhanced role of branding transformed that strategy, as global retailers looked for talented recruits with international experience and branding skills. The danger for the sector is that consumer demand – and correspondingly the need for top talent – will increase sharply at the same time as a legion of baby boomers in the sector reaches retirement age.

In order to compete effectively, organizations will have to quickly identify their best and brightest, decide the best way to retain them, and prepare them for early responsibility. For many this will represent a significant shift in talent management strategy. Internal investment in and development of talent will play a vital role in the ability of organizations in the sector to compete, as will the relatively unfamiliar process of identifying and differentiating those employees with the potential to make a significant impact on top line sales.

“We focus internally and only go to the market when we need to. We are looking for people who are creative and innovative in their approach and also have an innate sense of world-class fashion.” Benetton | India

“Bank Mandiri plays the role of a ‘talent factory’ but retaining that talent is a challenge because foreign banks want to leapfrog that development phase and buy local talent to start up the business immediately”

PT Bank Mandiri | Indonesia
Sector focus: Energy – engaging Generation Y

The challenge of engaging employees, particularly the demanding Generation Y, was especially evident for the energy sector respondents. Succession planning, engagement and communication were all highlighted as critical issues.

There is a chronic worldwide shortage of skilled engineering based specialists to cope with global demand during times of strong economic growth. The average employee age in the industry is 47 – creating succession issues both because they are seen as a block to the advancement of younger employees, and because of the prospect of a talent crunch in ten to fifteen years when they retire.

At the same time, not enough new skilled engineering specialists are being trained, and those that are, are often attracted into other sectors. Money – the traditional inducement offered by the sector, which pays well above the market for many roles – is only one of the considerations for this generation. Career advancement within the sector is seen as narrow and potentially blocked by the existing incumbents. Generation Y are also more likely to be concerned about the environmental image of the sector, and by the image of a workforce made up largely of middle-aged men.

The downturn has provided some breathing space for energy companies as talent demands have eased. The sector is beginning the next phase of its business on a cautiously optimistic note, as it is widely expected that demand for energy will move strongly ahead as economies recover, pulling the sector ahead in terms of global recovery. The inevitable consequence, though, is that the energy sector will need more talent to meet this demand if organizations are to compete effectively, and the best organizations in the sector recognize that they need a new model for engaging that talent.

For most energy organizations the challenge will be to build engagement and loyalty. In the past the debate has too often been focused on generous base pay and not on leaders and managers working to engage employees on the wider deal. Employees expect competitive pay, but they also expect challenging work, career prospects and realistic performance management. The ability to demonstrate a compelling employer value proposition, including but not defined by the competitiveness of the reward package, will be a key element of the talent defense strategy.

“We are placing a special focus on career development, leadership development, learning and growth initiatives to build future required capabilities and to contribute meaningfully to the skills shortage and unemployment concerns in South Africa. We have an additional focus on gender and the appointment, advancement and retention of previously disadvantaged groups.”

Sasol | South Africa
**Engagement is no longer optional**

In a challenging global economy where organizations are running lean, tapping into the discretionary effort of engaged employees is imperative. Our research has shown that organizations in the top quartile on engagement demonstrate revenue growth 2.5 times more than that of organizations in the bottom quartile, and those that score highly for both engagement and enablement have revenue growth 4.5 times higher.

Maintaining this engagement is challenging when the recession has left many organizations with a disaffected and worried workforce who are pessimistic about their future. In the current environment, many employees are focusing less on salary increases and more on job security – but organizations are acutely aware that, come the upturn, this will not last. Many organizations have also cut back on some of the most significant drivers of engagement, such as training and career development.

In this environment, leaders need to help employees understand that an organization has a coherent strategy that will allow it to succeed and that all employees have a role to play in helping the organization carry out its plans. Employees are being asked to make sacrifices for the organization and it is vital that they have a sense that decisions are being made rationally and equitably, and that the changes will result in better organizational effectiveness and an improvement in their work environment.

“*It is not easy to maintain a high level of engagement during a crisis, but leaders must be able to manage engagement even when they need to make unpopular decisions.*”

Pirelli | Italy

**India: Moving with the times**

While the Indian economy has suffered less than many, there has nonetheless been a marked change in the outlook of employees and employers. The opportunistic, job-hopping Indian employees of recent times are realizing they cannot sustain that trajectory, with its lack of opportunities for learning and development. Employers are also finding themselves under examination from candidates who are looking for long-term career prospects. Recruitment discussions are moving away from the boom-time focus on “how much money?” and “when will I get an increase?” to “what is the business plan?” and “how will this enrich my career?”

“In the Indian context, we find it difficult to be harsh on anyone especially since our appraisal matrices are not in place. So we reward for attributes and for effort rather than for results. The talent being inducted into the organization now is much younger than the current average staff age of 38 years. They get restless if they think they are to be measured using subjective processes and will soon move. Our reward management [is designed] to meet their expectations.”

Raymond Ltd | India
Engagement is not enough

Hay Group research shows that employee engagement alone does not guarantee an organization’s effectiveness. Many organizations enjoy high levels of engagement, yet still struggle to translate that to performance.

What is often missing in organizations that are struggling to see the results of engagement is ‘employee enablement’. In an enabled workforce, employees are effectively matched to positions to ensure that their skills and abilities are put to optimal use. Likewise, enabled employees have the essential resources – information, technology, tools and equipment, and financial support – to get the job done. They are able to focus on their key responsibilities without wasting time on non-essential tasks or navigating procedural restrictions.

Unfortunately, most organizations employ a sizable number of ‘frustrated’ workers – capable, engaged but not enabled. In the short-term, these motivated but poorly enabled employees may carry on and suffer in silence. But over time many can be expected to turn off and disengage – or tune out and leave.

The ultimate aim is that engaged and enabled employees will produce their best possible performance for the organization. This relentless focus on performance is a recurring feature of the study, as organizations seek to reverse some of the sloppy performance management practices that have crept in over the boom years when retention of employees was the priority. The first step in this process for many organizations is ensuring that they understand what performance looks like.

A new view on performance

Performance is no longer confined to the balance sheet. Many organizations are taking a broader view of performance that includes the impact on social, environmental and brand issues. As a result there is increased sensitivity to the need to balance short and long-term performance, and financial and non-financial measures of performance.

Some organizations – such as those in the public sector or some family-based companies which tend to value loyalty and ‘fit’ above performance – have not previously operated within a performance-focused culture. But the pressures of a tightened market mean that even these organizations are looking to introduce more of a performance focus.
There is now more attention being paid to the balance between financial and non-financial performance; it has been too financially oriented.

Large financial services organization | Europe
Risky vs responsible reward

The management of risk is an inherent element of reward. But this has not always been clearly articulated or understood. The credit crunch and recession have prompted many governments and regulators to seek to control and monitor reward more closely.

One of the many consequences of this has been an ongoing evolution in the role of the compensation committee, which is increasingly expected to oversee not only the compensation of executive directors, but to have oversight of variable pay arrangements across the organization, particularly from the perspective of risk.

Another consequence has been the introduction of a series of specific regulations governing the amount and type of reward that can be paid, and de facto regulation by taxation of specific types of reward, such as incentives. But these restrictions create artificial constructs that come with risks of their own. Some organizations, for instance, have sought to circumvent pay caps by increasing pension payments to key employees – despite the fact that pension packages have very limited motivational value and no links to corporate performance. Others have increased fixed pay to compensate for the deferral of bonus payments. Regulation, in other words, is a blunt tool and its effectiveness in terms of risk management is limited. The sheer volume of regulatory activity has arguably prevented organizations in the financial services sector, in particular, from focusing on developing a truly strategic approach to reward.

At Hay Group we believe that the most effective solution is for governments and organizations to take a holistic view of reward to ensure that, overall, the organization’s reward programs can reasonably be expected to drive long-term, sustainable performance. What’s more, that performance should not be defined solely by shareholder returns. It is also about trust and social responsibility.

In practical terms this means that organizations should be able to demonstrate that the behaviors that are stimulated by an organization’s reward and incentive programs are aligned with the long-term interests of all its stakeholders. We term this ‘responsible reward’ and, at its best, it is a strategy that builds a spirit of partnership to sustain the business, moderates excess and so reduces risk.

Hay Group’s research suggests that a successful responsible reward strategy:

- Enables the long-term sustainable success of the organization.
- Pays out over the same timescale that business value is created in.
- Is linked to a bundle of performance measures that reflect the impact of the activity not only on shareholder value but on the bigger picture.
- does not enrich management and employees to the detriment of shareholders.
- Takes account of the extent to which performance is driven by external factors beyond management or the employee’s control.
- Takes account of the risks inherent and capital employed in the business, and the impact this has on the returns required by shareholders.
- Achieves an appropriate balance between individual, team and corporate performance.
- Is competitive enough to attract the talent the business needs.
- Encourages rational thinking about the unique combination of economical and societal responsibilities of the individual company.
- Is justified in differentiating between the highest and least well paid by impact, workload, intensity and personal risk.
- Is actively, effectively and repeatedly communicated to employees and stakeholders.
- Recognizes that reward is more than pay.
The best system is not a substitute for management

Organizations are also investing in ensuring that their performance management systems and processes work to drive the performance they define. In some cases this means introducing more efficient systems and processes, and centralizing or automating performance management. But most recognize that those systems and processes will only work if they have the right culture and management skills to support it. The focus for many, as a result, was on building management skills around performance management, and on ensuring the transparency of the performance management process.

There is growing recognition that a performance management system is not a substitute for management. Responsibility for defining performance rests with leaders; and responsibility for managing performance in accordance with that definition rests with line managers. Provided line managers are supportive of senior executives, they are ideally placed to foster high levels of confidence in the organization’s leadership and direction and to help employees understand organizational expectations.

The other side of the coin is an increasing need to address low performers – to lift them up, or manage them out. Low performance may have been tolerated in the past but few organizations can afford to ‘carry’ anyone anymore. There is a general recognition that addressing poor performance is often a more challenging task than dealing with high performers, and again organizations are looking to better equip line managers to have those difficult conversations.

“We believe that our reward program has the ability to motivate high performers to do better as well as urging low performers not to lag behind.”

Godrej Industries Ltd | India
The impact on reward

The uncompromising, performance-oriented, post-recession world into which organizations are emerging has far-ranging implications for reward. For most organizations, direct reward costs have already been cut. Organizations are left with the challenge of coaxing better performance from their employees, often without the resources to fund a generous compensation strategy.

Performance is the key driver in the post-recession world. Reward – and a new focus on total reward that is closely tied to performance – will play a crucial role in allowing organizations to compete in this new environment. Variable pay, differentiated reward and performance metrics all play a vital role in this new strategy.

Aligning reward with the business

The survey confirmed that many organizations are working to align their reward and business strategies, either because their business strategy has changed or because alignment was not optimal. In practical terms this means ensuring that:
- The right performance metrics are in place
- Reward programs are closely tied to metrics
- Performance and rewards are appropriately differentiated
- Supporting management processes are in place
- Leaders have the capability and commitment to implement reward programs effectively.

CEOs and compensation committees are increasingly concerned about reward effectiveness and understanding the returns received for the company’s investment in rewards. To do that they are looking not only at benchmarked levels of remuneration for top talent, but increasingly they are also examining the total cost of their pay bills against their competitors, and asking the question: are we paying too much in aggregate?

Reward under the spotlight

The banking crisis and subsequent focus on executive pay has led to a marked increase in the oversight and governance of reward. In particular, the role of the compensation committee has expanded beyond the management of executive pay to include oversight of all reward-related risks.

Increased scrutiny from shareholders, the media and other stakeholders is leading many organizations to be more circumspect in their reward strategies. The end result is that at a time when management is looking for ways to be more nimble and innovative, they find themselves increasingly constrained. Strategic planning is in danger of being crowded out of the agenda as organizations struggle to tackle the rise in regulation and minimize the risks they face.
Sector focus: Financial services – regulation as a fact of life

While the financial services sector has been the focus of much of the increased regulation and scrutiny over reward practices in the wake of the financial crisis, this survey suggests that many organizations in the sector are taking governance changes in their stride. They may be most heavily impacted by regulation, but they were some of the least concerned about it. The most likely explanation is that compliance is a fact of life for these organizations and they already have the resources and skills in place to deal with it.

That said, most financial services organizations are changing their reward strategy to align with their business strategy and the changed regulatory and governance environment. Many are concerned about their ability to attract and retain talent with increasing restrictions on reward. In an attempt to address these concerns many are intensifying their talent development programs or turning to other sectors in the search for skills. As a result organizations continue to watch their competitors’ reward strategies carefully and place great value on external benchmarks.

Performance management is also a focus for many. Current performance management is seen as too complex, not aligned with overall corporate performance and weak in differentiating between high and poor performers. Many organizations are also struggling to find ways to address risk within the performance management process, and to incorporate non-financial measures in the assessment of performance.

The aim for many, ultimately, is a reward approach that achieves a better balance between short and long-term performance, between tangible and intangible benefits and between base and variable pay. There is a strong desire to involve line management in the process of reward and to improve transparency of communication for employees. For the time being, however, the issues of the day stand in the way of immediate progress.

“Regulatory compliance has become a significant driver since the financial crisis. This is, of course, most significant for the more senior management roles but may also have an impact lower down.” Large financial services organization | Europe
The changing face of reward

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A delicate balance – global vs local

A desire to cut costs and reduce risk has led an increasing number of organizations to centralize their reward decision-making and policy, and sometimes even administration. Advancements in technology have enabled a greater centralization of reward strategy over recent years and this trend is becoming more pronounced.

Centralization has the potential to allow organizations a clearer line of sight over their reward programs, meaning they can ensure local schemes align to global priorities and policies – increasing return on investment and reducing the risk of potentially damaging inconsistencies. The danger is that centralized policies can contradict sharply with local demands and practices, and may disengage local management if they are too restrictive. That said, organizations are continuing to allow for variations in business units or locations if it makes sense to do so.

For many, the concern is striking the right balance between global consistency and local adaptability, and allowing for proper recognition of varying local practices such as tax legislation, social benefits and regulation.

For global reward policies to work effectively, organizations need to have visibility over all of their remuneration components – not just base pay or total cash. Benefits and allowances frequently form a significant part of reward spend and are critical for competitiveness in many markets. The need to ensure the effectiveness of reward programs is motivating an increasing number of companies to determine the total cost of their reward programs and benchmark that against all the various markets they are active in. This is a trend we would expect to increase as more companies get to grips with the practicalities of operating effectively as a global organization.

The reward risk audit

The increasing globalization of business has created an enormously complex environment for managing reward, with organizations juggling with the demands of local regulation, market conditions, culture and tax structures. This complexity will be a concern for compensation committees struggling to come to grips with their expanded responsibilities.

Many will need to begin at the beginning, by identifying and assessing the risks inherent in their reward programs. A risk audit should be conducted across the organization, to provide senior management and the compensation committee with the information they need to make informed decisions.

Those decisions, however, should not be solely focused on reducing risk at the cost of innovation and competitiveness. An overly risk-averse approach to reward can be just as damaging to performance as an unmanaged, unrecognized risk. The answer lies in transparency and clarity from leadership about why the organization is doing what it is doing, and how reward strategy will drive performance.
Think globally, implement locally

The most frequent point of conflict in implementing a global remuneration strategy lies between the corporate philosophy and design components and the local country operations. Local regulations, practices and cultural expectations play a significant role in reward but can be lost or ignored in a centralized strategy.

Brazil, for example, is one of the most sophisticated markets in the world when it comes to short-term incentive programs. According to Hay Group research, 99 per cent of Brazilian organizations run a short-term incentive program for their employees and foreign competitors have frequently struggled to keep up. The emphasis on short-term incentives (and targets) lies in Brazil’s history of hyperinflation but continues to be actively encouraged through the country’s tax and legal system.

Russia, by contrast, is an environment where incentive-based reward has rarely been taken seriously (although many organizations are working hard to address this). Their experience of past economic crises means that many Russian employees prefer the security of base pay to uncertain bonuses. As an added complication, many Russian organizations overpaid and over-promoted workers during the boom years, leading to a weak and haphazard link between pay and performance. While many organizations are working to introduce a performance-based pay strategy, many challenges remain.

Imposing a global policy on variable pay without an understanding of the different markets is obviously not workable. Hay Group’s research has identified these key steps for the successful implementation of a global reward strategy:

- Form a global total remuneration strategy that is more than a mission statement and has clarity around non-negotiable areas
- Explain the global philosophy to all local countries and test it with them to identify in advance any unintended consequences that may result from local taxes, culture and employment practices
- Translate the global philosophy into local implementation plans
- Clearly spell out the rationale for employees
- Continually measure and tests the results on an employee satisfaction basis and against local markets.

“We are moving away from a ‘spread the peanut butter approach’ to one of ‘feed the eagles.’”

BMW Manufacturing | US
“Through worldwide analysis, we discovered that we have multiple different variable pay programs which has forced us to research a revised variable pay structure that will be consistent worldwide and will potentially include a company profitability threshold.”

BMW Manufacturing | US

“Sector focus: Manufacturing under siege”

The manufacturing sector has been one of the hardest hit by the recession. In a number of countries this has led to significant job losses and a major contraction of the industry as a whole.

Given the context, therefore, it is not surprising that the response more or less across the sector is to batten down the hatches, focusing on cost control and financial management. In terms of reward management, this means imposing greater central control on pay decisions and pay administration. If executed effectively, this should certainly assist organizations to gain control of their pay bills but it can also cause some significant problems.

A centralized approach can actually be damaging if front-line managers are not engaged or do not have enough discretion to be able to manage the process appropriately. They may come to believe that their needs have not been recognized by a remote and out of touch head office function. Hay Group’s research has consistently demonstrated the important part played by front-line managers in the effective execution of reward policy. Without their involvement, employees are less likely to understand or appreciate the reward packages provided by their organizations and the expenditure on reward is therefore less likely to be effective.

“The goal of corporate HR is to gradually give global direction and a framework to the local subsidiaries within which they can adapt to local practices.”

Makhteshim Agan | Israel
Differentiating reward

Organizations in all sectors are striving to forge a closer link between performance and reward. While this aspiration is nothing new, the difference now is that the challenges it brings can no longer be placed into the ‘too hard basket’.

Many respondents to the survey talked about a general shift from a culture of ‘entitlement’, ‘paternalism’ and ‘comfort’ to one of ‘performance’. In practical terms this is leading to a greater differentiation of reward based on individual performance. The limited budget that is available is being put behind high-performers and key roles that are seen as critical to the business.

Hay Group’s research into the reward strategies of Fortune’s Most Admired Companies has shown that the best organizations carefully target their use of differentiated reward.

When bonuses are taken into account, senior managers in the world’s top organizations can earn 20 per cent more than their peers. These people are being rewarded for their ability to deliver and ensure that their organizations stay at the top of their sector – they are driving the strategy and motivating their people.

Top six pay-for-performance actions

1. Introducing differentiated reward structures where available rewards increasingly go to the top performers and high potentials; those critical to the survival of the business, now and in the future

2. Building line management skills in setting goals, coaching performance and recognizing and rewarding performance

3. Clarifying definitions of performance

4. Balancing individual and enterprise targets for bonuses

5. Aligning individual targets to overall strategy

6. Making greater use of multiple rewards, mixing short and long-term incentives with the motivational stimulus of better career development and varied and interesting work.

“‘A ‘one size fits all’ reward program will not be applicable. The trend will go to ‘one size fits me’.”

Essent | Netherlands
The ‘right’ performance matters

Organizations are seeking to realign their performance metrics to their strategies and goals. There is increasing recognition of the need to manage risk by driving the ‘right’ performance – behavior as well as output, results not activities.

While there are no easy answers and different approaches will be adopted for different reasons, the overall instinct is 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.

The false security of ‘hard’ measures

It is clear from the survey that some organizations are placing more emphasis on financial measures in rewarding performance. Times are tight, and organizations want to know that they are going to get a return on the money they invest into their reward programs.

However, this emphasis on financial goals and metrics is at odds with what we know Fortune’s Most Admired Companies do. While peer companies apply performance metrics to executives 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.

There is a risk that concern for bottom-line performance may drive some companies to ignore the risky side effects that come with an over-focus on narrow performance goals. These include a rise in unethical behavior, an over-emphasis on one area of the business at the expense of others, and distorted risk preferences – look no further than Enron and the sub-prime mortgage lending that triggered the credit crunch for evidence.

Whatever goals are set, it will never take away the need to arrive at a ‘holistic’ view of an individual’s performance over a given period that takes into account financial impact, behaviors and values. Responsible reward, in other words, is the key to a truly successful reward strategy.

“...everyone has different perspectives on pay for performance, performance ranking and differentiated rewards. It is an implementation issue rather than a strategy issue.”

Large multinational manufacturer
Variable pay comes into its own

An increasing trend as organizations emerge from the recession is a shift in balance between fixed and variable pay. This is partly cost-driven, as those organizations with higher proportions of variable pay (and therefore the flexibility to cope with economic volatility) have often been better placed to survive without shedding jobs.

Variable pay is also a critical lever for motivating performance and engaging employees in the organization’s goals. The best organizations are using variable pay not purely as a cash flow tool but as a support mechanism for their performance management strategy. In these organizations the challenge is to develop an appropriate balance between short and long-term incentives based on the nature of the role, with many organizations increasing the opportunities for long-term incentive awards. Short-term incentives are pushed further down the organization to convey that individual performance affects the success (or otherwise) of the business.

Five common trends in variable pay

1. Linking bonuses to medium and longer-term targets that support sustainability and organization performance over the longer-term

2. Ensuring bonuses are properly funded, with a focus on growing the bottom line as the main driver

3. Balancing individual and enterprise performance in designing bonuses

4. Simplifying programs, in particular by reducing the number and variety of bonus schemes

5. Clarifying and communicating the intent and design of variable pay.

“The technical, financial and other support areas should have initiatives and targets that effectively translate each person’s contribution to business results, but that also represent a comparable challenge for leaders.”

Companhia Energetica de Minas Gerais | Brazil
Variable pay…varies

Variable pay does not look the same in every organization. How it works and how it is structured depends heavily on organizational culture and the interdependencies with other elements of the reward program.

One of the most significant challenges in implementing a variable pay structure lies in balancing competing stimuli and risks. If a bonus scheme fails to pay out in a bad year, one of the consequences can be employees who are disengaged at a time when the organization needs them most. Conversely, a bonus scheme that pays out regardless of corporate performance will quickly be seen as an entitlement and will fail to drive discretionary effort.

Here are two very different approaches – both of them valid – that illustrate how variable pay works in different contexts.

The automotive company Pirelli and the global cement manufacturer Italcementi are two of Italy's best-known large companies. Both were impacted sharply by the global downturn, although Pirelli felt the effects earlier than Italcementi. Pirelli went through a restructuring early in 2009, with the aim of achieving a more performance-focused culture. It introduced a new system where 75 per cent of variable pay is long-term and targets are based on company performance.

“Our reward system is strongly impacted by our performance culture – we have a very practical and serious approach to variable pay. Just to give you an example, there are two threshold objectives before you can get the bonus. In 2009 – a critical year for the business – the majority of our management didn't receive any bonus payout.”  

Pirelli | Italy

In contrast, Italcementi was dealing with a workforce that had already been hit by staff reductions and wage freezes. Continuing to set highly challenging targets for variable pay risked further reducing the motivation of employees.

“We have a good variable pay system in place that allows us to be competitive in the market. In 2009, we set a budget and MBO targets in line with the economic environment. This year those targets will be reached and reasonable bonuses will be paid. We think that in hard times it is important to have targets that are reasonably challenging and can sustain performance exactly when you need the highest motivation.”  

Italcementi | Italy

The challenge for organizations is not only identifying the right measure, but the right target. 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 you award average performance? Or only excellent performance? There is no one correct answer. Organizations need to consider their culture, business needs and overall reward program to decide the best road to follow.
Watching the market

While there is clear evidence that organizations are paying enormous attention to the link between pay and performance, they are still keeping a close eye on the reward strategies of their competitors and on market trends. Participants in this study were very clear that market benchmarking remains a primary design factor in reward. A high proportion of organizations were looking to refine how they benchmarked, driven by a desire to make sure they were not paying over the odds, and by a general need for greater transparency. With senior management taking an active interest in reward, they want to know why the organization is paying what it is.

Benchmarking, as a result, remains critical, but market data is being used in a different way. Organizations are looking for a better context for their data so they can clearly justify decisions made on the basis of it. They are also using that data in different ways – the focus on benchmarking is particularly strong in developing markets and in high-growth companies, and when considering key roles and talent. In developed markets and slow or no-growth companies, they are more likely to be looking for ways to balance evidence from market benchmarks with affordability. The focus is now less on competitiveness and more on maximizing the return on investment from reward spend.

Changes to the way organizations benchmark, and the data they use, are also on the horizon. Many organizations are looking to measure and, increasingly, communicate to their employees the total value of their reward package. The increasing centralization of reward management and the desire to have greater visibility over total reward spend also means organizations are looking more at total remuneration rather than just total cash.

Say what you need to say

The new trends in reward strategy cannot succeed without a solid foundation of good communication, based on strong leadership. At every stage – the drive towards variable pay, a closer link between performance and reward, differentiation of high and low performers, retention of talent and a trend towards total reward – there is a risk that the return on investment will be lost because leaders and managers have not clearly communicated the organization’s intention and strategy.

Hay Group’s research into Fortune’s Most Admired Companies revealed an emphasis on promoting the total rewards view – the best organizations do not necessarily offer more intangible rewards than their peers, but they do a much better job of communicating what they do offer and of making employees understand their value. The best organizations develop a course of action that weaves the reward program messages into the fabric of the organization; ensuring core messages are clearly communicated and reinforced frequently; using total reward statements, and engaging line managers, early and often.

“We need to have a broader view of the market we are competing in and a critical eye when choosing our peer group, according to the levels in our job structure.”

Braskem | Brazil

“Right now, affordability is more important than competitiveness.”

Multinational manufacturing organization
“You can never do enough communication about pay and benefits. Ideally, this should be a straight conversation between the manager and the employee.”
Philips | Netherlands

**Case study: Part of the family**

PT Trakindo Utama, a family-owned company based in Jakarta sees employee engagement as its first priority and describes itself as ‘protective about the talent and knowledge’ of its employees. During the Asian financial crisis in 1998 the company retained all of its permanent employees in the belief that their skills and loyalty would be invaluable once the economy began to rebuild. The company took a similar approach during the most recent downturn:

“During [both] crises, our employees felt that they were taken care of. The family received a lot of ‘thank you’ letter from employees for protecting their interests and providing stability for them and for the company.”

The company’s founder and senior management have also taken unusual steps to foster a culture within the organization that is based on strong family values.

“Engagement is our number one priority. By 2007 when many positions within our company were filled with fresh university graduates and over 50 per cent of the workforce was aged 35 and under, the family felt that some Indonesian aspects of core values and character had been compromised in the euphoria of democracy. As a result, the founder of the company wrote a book about the values and principals he used to build and run the company in an ethical way. Based on that, we developed core values videos, core values booklets and training, to remind people what the soul and glue of the company is. For many people these values are why they joined and stayed with the company.”

The survey showed that many organizations understand the importance of good communication and recognize that reward is not always well understood by their people. They are investing in communication tools such as total reward statements to ensure that employees have a clear picture of the overall value of their reward package – not just the base pay component.

“Distilling the message and getting line managers to really buy it as well is critical to effective communication.”

Multinational manufacturing organization
The recession has accelerated some long-term trends in the sector. Key players are realizing that they need the operational efficiency of retail, coupled with the regulatory nous of life sciences, all supplemented with the consumer savvy and responsiveness of manufacturing and FMCG. And of course, organizations are now beginning to recognize the role of the manager in driving performance and efficient reward.

While reward issues are not immediately top of the agenda, many see an efficient reward policy as a key enabler to attract and retain the right talent, support the corporate goals, and create the conditions for delivery. In practice, this means a renewed emphasis on pay for performance, cost reduction, and making sure that the reward system drives the right behaviors to deliver on goals. During the boom years there was room for inefficiency and if the performance element was not quite right, it could easily be overlooked. Now, organizations are looking to managers to really manage.

“The new plan is fairer for both the company and employees, based on profits and results with performance measures a mix of individual and corporate goals. We have been investing in management development so managers can effectively lead their teams: clearly defining targets, agreeing on expectations, and managing remuneration in line with performance.”

Algar | Brazil

Improving general management skills is key to delivering on the apparent paradox of reduced reward budgets and improved employee engagement and productivity. Yet Hay Group shows that this square can be circled: with the world’s best companies typically paying less than their averagely-performing counterparts. A key element of this is communication, but less than 10 per cent of CMT organizations mention the role of managers in communicating reward.

The keys to success in the new operating environment are: a recognition of the power of an efficient reward system in driving performance, coupled with real performance management and an emphasis of the role of managers in ensuring that the organizations resources (people and reward budget) entrusted to them are put to good use. The sooner companies can grasp this issue, the more likely they will be able to beat the competition.
The implications for reward

_in many ways, the recession has been a wake-up call for reward. Sloppy practice crept into reward processes during the boom years and the economic downturn has forced many organizations to think more sharply about who – and what – they are paying for._

The keys to effective reward

Keeping the following principles in mind will help those managers responsible for rewards to ensure their reward programs effectively support business strategy.

1. Create a performance culture. Use your reward programs to help you move from an ‘entitlement’ to a ‘performance’ culture. Consider whether the measures that underpin variable pay are optimal for driving performance. Look at how to differentiate reward for high performers so that it acts to engage not just your ‘stars’, but all your people.

2. Think in terms of total rewards. Our research has consistently shown that intangible benefits such as career development opportunities play a vital role in employee engagement. This is one of the many reasons that organizations should not lose sight of total reward – the total benefits employees receive from working for a company.

3. Consider all costs. While many organizations closely focused on reward costs during the recession, this was sometimes at the expense of a wider contextual consideration of cost. It is too easy in the current climate to overlook the total cost of reward – benefits and allowances can account for as much as 40 per cent of reward costs.

4. Build in flexibility. Bonuses not only focus attention on key goals, they also provide a cost buffer in downturns. Increasing the proportion of total pay delivered through bonuses provides employers with greater flexibility in their cost structures, and helps to protect jobs.

5. Make a thorough assessment of risk. Risk is inherent in reward programs – not least the danger of encouraging risky behaviour through variable pay which has been sharply highlighted by the financial crisis – and should be frequently and thoroughly assessed. Strong risk assessment procedures will also serve to support the work and meet the requirements of the compensation committee, which is playing an increased role in reward.

6. Balance global and local requirements. With centralization of reward strategy on the increase, the challenge for multinational companies is to ensure they hit the right balance between global consistency and local autonomy. A close assessment of the effectiveness of reward programs at both global and local level is essential to a successful strategy.

7. Reward effectiveness. Reward programs need to deliver a clear return on investment. Clarify what you expect your reward programs to deliver – whether it be engagement, retention, performance on critical success factors, or some other measure. Make sure you have the means of measuring progress, such as employee satisfaction surveys.

8. Nurture innovation. The survey highlights the tension between the need to reduce risk and meet compliance requirements and the desire to develop new reward policies and programs that better support the needs of the business. The risk that innovation will be stifled by increased regulation remains a serious concern. Reward managers in particular need to be vigilant and identify when innovation is at risk.
For many, the recession has been an opportunity to retrench and reassess. Organizations have seized the chance to clarify their reward strategy and seal any cracks in the foundations, improving and strengthening their reward and performance management systems. Panic and the need to cut costs may have been the significant drivers but the lasting legacy is a concentration on the optimization of pay.

**The reward ‘to do’ list**

| 1. | Review reward strategy to ensure that it supports business strategy. |
| 2. | Reassess performance criteria so reward is linked more closely to goals that clearly reflect the vision and strategy of the organization. |
| 3. | Review the balance of variable and fixed pay to ensure it is right for the company culture and for business needs. |
| 4. | Use reward differentiation (where appropriate) to focus limited resources on those most successful to the business: high performers, high potentials and those with skills that are in short supply. |
| 5. | Closely assess and measure the return on investment from reward programs and strategy. |
| 6. | Communicate the true value of your reward package, and how it supports the goals of your business. |
The survey was conducted in October and November 2009 via face-to-face or telephone interviews, using open-ended questions. It was designed to draw out the issues which were ‘top of mind’ for respondents on the topics covered. A thematic analysis of the questionnaires then identified the common themes from those responses.

**Sample profile**

The majority of respondents were HR specialists, with around two thirds of those at director level and one third at manager level. There were a small number of senior and line manager respondents. Around 40 per cent had a global remit, 20 per cent had a regional remit and 40 per cent had local responsibilities. Half reported directly in to senior management (CEO, COO or board). Almost half were based in Europe, a quarter in Asia, a sixth in North America and others evenly distributed across South America, Africa and Pacific.

The organizations who took part in the survey manage revenue streams of approximately US$4.5 trillion and employ around 4.7 million people in total. Of the organizations represented in the survey, three quarters were multinational, with a fifth operating in more than 50 countries. A fifth have revenues of US$10 billion or more, around half have revenues of between US$1 billion and US$10 billion, and the remainder have revenues of over US$100 million. Around 40 per cent had between 10,000 and 100,000 employees and a similar proportion had between 100 and 10,000 employees. Profiles were fast moving consumer goods and retail, telecommunications and IT, financial services, manufacturing, energy and life sciences.
Role of respondents:
- Manager level
- Director level

Scope of role:
- Local
- Global
- Regional

Region:
- Europe
- Asia
- North America
- South America
- Africa
- Pacific

Sector:
- FMCG/Retail
- Manufacturing
- Energy
- Life sciences
- Telco and IT
- Financial
- Other

Number of countries in which organizations has operations:
- < 5
- 5 – 19
- 20 – 49
- > 50
A further 31 organizations took part in the study but wished to remain anonymous.
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.

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