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Performance-Related Pay
in the Context of the Global Crisis

The concept of performance-related pay has taken a battering lately. Some blame the practice for driving the excessive risk taking within the financial services sector, which led to the global economic crisis. Whatever your view on the causes of the global economic crisis, it would be wrong to think that performance-related pay is history. In fact, one of the consequences of the economic downturn is that many organizations have become even more focused on managing their compensation and benefits cost structure as a whole. Organizations are now discovering how little of their compensation and benefits cost structure actually depends on employee or organization performance.

QUICK LOOK

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- Employees, generally speaking, have had little to no expectation of salary increases in the short term.
- If organizations find themselves in a position such that the budget available for 2010 is 2 percent or less, they should consider applying the increases in a targeted way.

By Pat Gurren

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The harsh reality is that even though business performance has fallen, the compensation and benefits cost structure is, for the most part, fixed and even increasing in some areas such as pensions and health care. A logical consequence of a greater focus on managing the compensation and benefits cost structure is that organizations will strive to deliver more performance-related pay over the medium to long term.

This article outlines the key approaches to performance-related pay that organizations are adopting in order to navigate through the impact of the global economic crisis. The approaches outlined may not be practical in all geographies and/or employee categories around the world, given local and national collective agreements and/or local employment laws. However, they at least merit consideration given the reach of the economic crisis.

Base Pay Adjustment Processes

One of the immediate consequences of the economic crisis is that organizations have little or no money to make annual adjustments to employees' base salaries. In the short term, this has not been an issue since the competitive market for labor has significantly fallen. Employees, generally speaking, have had little to no expectation of salary increases in the short term.

In the medium to long term, organizations will need to prepare for the economic recovery and, in particular, the need to retain their high-performing employees and keep them engaged. Historically, organizations have come out of salary freeze mode, which normally lasts for a year or so, to revert back to the practice of delivering annual pay adjustments, albeit with increases that are below historical norms.

This time around, the economic crisis is deeper; organizations are responding in different ways. The following are the key approaches organizations are adopting or will adopt in relation to the management of employees' base pay.

- **Institute multiyear (at least two years) pay freezes.** An October 2009 Watson Wyatt survey of 700 organizations across Europe, the Middle East and Africa (EMEA) found that salary increase budgets will be tighter in 2010. Specifically, it found that 40 percent of companies who had implemented pay freezes in 2009 had not decided to lift the freeze for 2010 at the time of the survey. It is the author's view that it is inevitable that some organizations will be faced with little choice but to hold base salaries flat for two years in a row. This experience will be unprecedented for most organizations, managers and employees. Some will be forced to do so simply because they don't have the financial resources to deliver increases. Other companies, with limited financial resources, will think long and hard about doing so, given the uncertainties and the realities of a cool market for labor.

In framing the decision on whether to apply increases or not, it stands to reason that organizations will be forced to look increasingly inward rather than looking externally. Historically, there has been a heavy reliance around what the market is doing that guides decisions related to the size of annual salary increase budgets. It is unlikely, given all the uncertainty in the market, that organizations will glean sufficient clarity on the right decision, since the market will present a mixed picture of practices including pay cuts, continued pay freezes and pay increases. Organizations should look internally at their own performance, their culture and values, their HR strategy, and their compensation and benefits cost structure to guide them to the right course of action.

- **Apply limited salary increases such as 1 percent or 2 percent of payroll.** If organizations find themselves in a position such that the budget available for 2010 is 2 percent or less, they should consider applying the increases in a targeted way versus diluting the impact of the available budget by spreading the limited increases across the entire employee population. If budgets of this size are applied across all employees, the impact is, at best, neutral and, in some cases, counterproductive; employees see the increases as meaningless, even insulting. By taking a targeted approach, organizations can deliver significant and meaningful increases to key employee populations based on either performance, criticality to organization needs or market vulnerability. It is important to note that organizations should customize, for example, by awarding the top 25 percent of the employee population an average increase of 8 percent, with a 2-percent budget. Or deliver a 4-percent increase to half of the employee population with a 2-percent budget. Organizations do, however, need to give considerable thought to the impact this approach will have on the entire employee population. In the author's experience, a robust communication strategy is essential for success. Furthermore, this practice works more effectively in organizations that have a strong

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culture of performance management and openness in their dealings with employees.

- **Deliver increases in the form of a lump sum.** Organizations that are hesitant to deliver increases into base pay but wish to recognize/reward employees can deliver increases (e.g., 3 percent of payroll) in the form of a lump-sum payment. Organizations can follow their normal performance management cycle and, rather than consolidating the increase into employee base pay, can pay the annual increase in the form of a lump-sum payment. A retention element can also be factored into the payment, which requires a prorated amount to be paid back to the company if the employee leaves the company before the end of the review period. A further significant advantage of this approach is that there is cost impact on other programs that are linked to base pay, such as pensions.
- **Deliver pay cuts.** In some circumstances the economic crisis is resulting in organizations being forced to reduce base pay levels. A drastic example of this is the Irish Republic, where more than 350,000 public-sector employees have seen their base pay cut by an average of 14 percent (7.5 percent in the form of a pension levy in 2009 and 6.5 percent in an average base pay cut in 2010). Within the private sector in Ireland, a recent survey of large private-sector employers by Watson Wyatt showed that 26 percent of companies had implemented an average pay freeze of 6.5 percent in 2009. In addition to all the usual issues that go with such actions, there can also be a structural impact (depending on how the cuts are made) for organizations that have a history of performance-related pay. Pay cuts can have the effect of undoing or rolling back the history of performance-related pay increases, simply because pay cuts are normally done on a percent basis. So, an employee with a history of above-average pay increases will suffer a greater monetary reduction in pay than an employee with an average level of performance. This may be unavoidable in the short term, but organizations need to think about how to address impact on high-performing employees in the medium to long term.

Salary Range Structures

It may appear somewhat unusual to be dealing with salary range structures in an article on performance-related pay. We are living in unusual times in that we are experiencing a significant level of pay freezes, cuts to base pay levels in some organizations and a significant increase in the levels of unemployment. All of these factors have placed significant downward pressure on market rates. The situation we are now in is significantly different that what most organizations experienced during the past 10 years, when there was significant upward pressure on market rates and salary range structures.

In the current economic environment, organizations need to take a cold, hard look at their salary range structure and decide if it is appropriate in the new economic climate. The salary range midpoint (or reference points) needs to be reviewed to ensure that it truly reflects the current market value of job roles. Organizations should also review the distance between the minimum and maximum of the pay ranges (the spread) to ensure that these are also appropriate. It has been the author's experience that some organizations have midpoints and salary range maximums that are out of sync with the new economic environment.

Bonus/Incentive Plans

There has been a lot of press during the past year describing the likely impact of increased governance requirements on bonus/incentive payments in the worldwide financial services sector. It is not possible to be definitive on the likely impact of this until the governance regime is fully detailed and implemented, and it is clear as to what resources will be driving compliance. However, it can be said that bonus and incentive payments will continue to play a significant role in the total rewards package not just within the financial services sector, but across all industry sectors. The reason for this is simple: Organizations continue to have a requirement to incentivize employees to perform in order to improve organization performance.

The following are the key approaches organizations are adopting or should adopt in relation to the management of employees bonus/incentive plans:

- **Clearer linkage between the bonus/incentive and the organization's bottom line.** A consequence of the economic jolt many organizations are experiencing is that they will question more closely the value they are getting from their bonus plans in terms of increased organization performance and the employee behaviors being rewarded. The link between the bonus/incentive criteria and the bottom-line business results will need to be clearer going forward.
- **More rules versus guidelines.** The economic crisis is leading to a review of the design of bonus and incentive plans, with clearer rules versus guidelines. In addition, clearer performance criteria are being put in place. Business and organizations will look to deliver better value from their bonus/incentive plans by being more prescriptive on performance criteria and the rules governing plan operation. Within the financial sector, they have the added challenge of increased governance requirements on bonus/incentive plans for senior employees.
- **Fixed versus variable mix within compensation and benefits cost structure.** Many organizations have come to the realization that they need to shift the mix (fixed versus variable) within their compensation and benefits cost structure over time. The pain some organizations have experienced in this economic downturn by virtue of having a structure that is not leveraged sufficiently on variable pay will drive them to address this mix to keep it in line with their business or organization requirements over the longer term.

Conclusion

The global economic downturn is bringing about a sharper focus on performance-related pay. This sharper focus is leading to companies adopting practices that they would not have even considered at the top of the economic cycle. Organizations are expecting a stronger linkage between the design of bonus/incentive plans and improved organization performance. In terms of base pay management, organizations are increasingly focused on ensuring any increases applied are delivered to those employees who have the most impact on business results. Some organizations are also taking the opportunity to ensure that base pay costs are aligned with what the organization can afford as well as the realities of the current market for labor. WS

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