Performance-Driven Compensation: The Corporate Talent Insurance Policy
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Introduction

An average company’s biggest expense—and biggest differentiator—is its talent. As much as 70 percent of business expense is on people: hiring, salary, and benefits. Yet in the U.S. alone, the average churn of staff is a staggering 40 percent. More alarming: in 2009, half of that churn was voluntary—people deciding to leave their jobs to find something better.

As economic conditions improve and businesses worldwide look to regroup and even reinvent themselves, smart talent management has never been more crucial. Central to that strategy is managing risk through talent insurance policies that more accurately find and incent the best performers with differentiated compensation. More than 80 percent of companies around the world are offering variable-pay programs or performance-based awards that must be re-earned each year.

This white paper explores the genesis of differentiated compensation and outlines how to create strategy, process, and supporting technology infrastructure to move from “good enough” compensation management to a program that aligns employee compensation to a company’s key business goals.

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Compensation as a Talent Insurance Policy

Why do companies need insurance? Insurance provides a means to mitigate the negative impact of foreseen and unforeseen events on the business. The job of corporate risk managers is to eliminate visible hazards that could increase the probability of damaging events.

Executives are themselves risk managers when it comes to their most valuable assets: their talent. McKinsey & Company’s groundbreaking research in 1997 on competition for talent implied that top performers and high-potential employees were scarce and needed to be treated as precious resources. Today, despite high global unemployment, this concept is no less true.

As has been the case for decades, top talent always has employment options and rarely has to actively seek out good opportunities. Surprisingly, according to the U.S. Bureau of Labor Statistics, voluntary turnover rates were about 20 percent in the United States in 2009. This was in the face of an economic downturn that contributed to an unemployment rate of more than 10 percent of the population.

So, how do executives create the talent insurance needed to mitigate the risk of losing their top talent? One pivotal strategy—recently enabled with technology—is to tightly link employee and business performance to compensation and other rewards.

Pay for Performance

The idea of paying employees for their impact on the business can be traced back to ancient times. Pay for performance is an admirable goal for managers, yet businesses have struggled with implementing these practices.

Figure 1. Highly differentiated compensation is an admirable goal but can be difficult for managers to execute.

Cultural barriers play a significant role in this struggle. Pay for performance requires managers to clearly articulate expectations for employees and then have frank, honest dialogue with these employees about accomplishments, shortfalls, and competency gaps.

These conversations require management skill. Yet many managers lack the training needed to effectively assess performance and provide coaching and feedback. Regardless of management training, there is a further complication in consistent application or performance calibration of assessments between managers within departments, divisions, and across the company.

The result of being unable to objectively create and align goals and differentiate employee performance against these goals is often a contributor to a “peanut-butter” approach to compensation. This approach—while well intentioned to be fair to all staff—takes available merit and bonus budgets and spreads them somewhat uniformly across the entire employee base. The outcome is anything but fair—to the key performers or to the business itself. Diluting the impact of the bonus pool in turn dilutes the perceived value of the incentive.

Evenly spread compensation definitely alleviates the short-term pain of having to hold difficult conversations with employees or attempting to ensure assessment calibration across all reviews in an organization. However, the long-term effect is that top performers lose motivation in their work as they see their results rewarded in much the same way as lower-performing coworkers. The unfortunate consequence: a company increases its risk of losing the very people who are giving it a competitive edge in the market. Top performers will look for companies that recognize and reward high productivity with disproportionately weighted compensation models.

Another key barrier in achieving a true pay-for-performance model is the lack of automation tools that have been available. These methods make it extremely difficult to have a single view of performance and compensation data linked together, provide performance calibration, and ensure the right people are aligned with the right compensation and incentive options.

Today, this alignment is often done manually. The vast majority of performance and talent management software systems (more than 90 percent by our estimates) are not integrated with a compensation system. This means the company completes its annual performance management process, prints out the results, and then re-enters those results (or lets managers enter them) into their compensation changes. Such an approach is error-prone and time-consuming, and makes a “total-rewards” strategy difficult to implement.5

Out of six key priorities provided to respondents, organizations identified employee engagement and talent management as the most significant to professionals (almost 70 percent each). 69 percent of organizations said they were concerned about the retention of high performers and 63 percent of organizations use salary increases as a mechanism for rewarding their high performers. Schemes for recognition, talent management, and career development are used by 39 percent, 41 percent, and 47 percent, respectively. Encouragingly, only 9 percent are not using any form of reward mechanism for their high performers. 6

Notably, just 19 percent of respondents to a Taleo Research 7 study in the U.K. stated that their employer calculates bonuses using personal performance targets linked to business goals. 8 Without the talent management skills or the companywide view of talent, companies are increasing their risks with the vast majority of their costs. The more strategic the talent is to the business operation, the greater the exposure.

Top Performers and High Potentials

CEOs and senior executives are aware of the criticality of hiring, engaging, and retaining high performers for their organizations: 97 percent of CEOs in a global survey responded that access to, and retention of, key talent is their #1 source of competitive advantage in sustaining growth over the long-term. 9

What defines a top performer or a high-potential employee? Talent management analyst firm Bersin & Associates defines the difference as follows:

A high performer is an employee who:

- Is a key contributor
- Demonstrates high performance
- Is capable of a lateral move
- May be qualified for a broader role within the same profession
- Has reached the potential to move upward in a management capacity

By comparison, a high-potential employee (often referred to as “HiPo”) is a high performer who has also been identified as having the potential, ability, and aspiration for successive leadership positions within the company, typically two levels or more. 10

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6 Hay Group U.K., “Reward in 2010 Research.”
7 Oracle acquired Taleo in June 2012.
The “War for Talent” study crystallized the impact of quality performers.\textsuperscript{11} It found that in the opinion of senior managers, high performers outperform average performers by a wide margin. According to the study, high performers in operations roles are able to increase productivity by 40 percent, high performers in management roles increase profits by 49 percent, and in sales positions high performers are responsible for 67 percent greater revenue.

\begin{figure}
\centering
\includegraphics[width=\textwidth]{figure2.png}
\caption{Good people are great for business.\textsuperscript{12}}
\end{figure}

Given the enormous difference in productivity between average and top performers, it seems that common sense would dictate weighting a large share of available compensation budgets to these resources. Yet executive coach and author Dr. Marshall Goldsmith asked more than 2,000 corporate managers about the difference in pay between a top performer and a below-average performer of the same grade. The answer: a surprisingly low 5 percent to 10 percent difference in pay, while these same managers indicated that the difference in contribution to the business from these performers was more than 100 percent.\textsuperscript{13}

The unpredictability of what businesses have experienced since the 2009 recession makes compensation planners acutely aware of the need to keep costs under control while balancing the need to attract, motivate, and retain workers with the right talent and skills to ensure business success.\textsuperscript{14}

\begin{enumerate}
\item The Conference Board of Canada, “Modest Increase in Pay Expected for Canadian Workers in 2010.”
\end{enumerate}
Figure 3. A variety of measures were taken by companies to control compensation costs during the recession. 15

While there are a multitude of tactics that can be used to retain top performers and high-potential employees, compensation is a way to mitigate risk and lower hiring costs.

However, when top talent decides to leave a company, there is significant cost in addition to the loss of productivity. Multiple research studies have shown that the cost of replacing an employee can be as high as three times their annual salary. This double whammy of decreased productivity and increased hiring makes it easy to see why executives are focused on retaining critical talent.

Finally, retaining critical talent has impact beyond increased productivity. As companies create plans to grow by looking for new markets and introducing new products, their leadership pipelines and the bench strength of employees for critical positions takes on new importance. Making sure the high-potential employees that make up this talent pipeline are engaged and rewarded appropriately is a constant challenge for executives.

These statistics highlight the significant business lever that executives have—but don’t always optimize—in the quest to create high-performance cultures. The challenge is marrying top business goals to strategic execution.

The Advantages and Complexities of Differentiated Compensation

Today’s compensation and talent management professionals are looking strategically at the role of performance-driven rewards as a key lever for engaging and retaining top performers. There are numerous strategies for creating a high-performance culture, and today’s technology advances have created major opportunities for looking at performance assessment and compensation structures differently than in the past.

Historically, companies had fairly narrow boundaries for compensation plans. The major levers were the merit increase for base pay and bonuses for achievement of goals. While these are still primary, compensation departments are looking more broadly at other variable pay mechanisms that take into account business performance in addition to employee performance.

The most basic example of this type of reward mechanism is to tie a portion of an employee’s compensation to the company’s financial performance measures, such as sales or revenue at company, division, or even departmental levels. This is an easily available metric that all employees understand. The issue is that the linkage of employee work to this particular measure might not be clear-cut.

<table>
<thead>
<tr>
<th>TABLE 1. COMPENSATION COMPONENTS TO BE REDESIGNED OVER THE NEXT 12 MONTHS 16:</th>
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<tbody>
<tr>
<td><strong>RESPONSE</strong></td>
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<tr>
<td>Variable pay</td>
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<td>Base pay</td>
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<td>Sales compensation plans</td>
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<td>Equity</td>
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<td>Nonqualified deferred compensation plan</td>
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<tr>
<td>Employee stock purchase plans</td>
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To circle back to the notion of risk management and insurance, variable reward programs can be thought of as profit insurance. When a company has lower than expected profits, variable compensation budgets are reduced to mitigate any shareholder impact. This is not punitive, as the shareholders have based their investment on the performance of the company and employee actions are directly linked to this performance. On the flip side of the coin, when the company’s profits exceed

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targets, the bonus pool is deepened and employees reap the benefits of the linkage between their performance and the exceptional results.

One U.K. study found that top reward priorities were ensuring that the reward was aligned with the business strategy (52 percent) and ensuring that reward packages were market competitive (51 percent). While cost minimization was still one of the key priorities, it had slipped to being as equal a priority as ensuring the reward is internally fair (44 percent).\(^\text{17}\)

Other business success metrics being linked to employee compensation include customer satisfaction, customer retention, and customer support. These get a bit trickier to map to individual levels, yet they are critical to a company’s success.

Savvy businesses are also looking at other incentives to retain top performers. Grants of stock options and full value shares, education and other development activities, and spot bonuses are also being factored into differentiated compensation plans. Interestingly, top talent rarely leaves a company for compensation reasons alone.

Figure 4. Top talent rarely leaves a company for compensation reasons alone. \(^\text{18}\)

Multiple studies cite that a lack of employee development activities is a key decision point for top performers. Therefore, using development activities—whether they are educational opportunities, formal mentor relationships, or stretch assignments—as rewards for top performance is cost-effective and helps enhance retention. This is potentially powerful insurance for key players in the organization. But for compensation professionals, it is increasingly complex to design, administer, and keep current.

\(^\text{17}\) Chartered Institute of Personnel and Development (CIPD), “2010 Reward Survey.”

\(^\text{18}\) “Connecting the Dots,” Hewitt Quarterly Asia Pacific, Volume 7/Issue 1.
The more tightly aligned the high-performance culture, the more complex the compensation scenarios. Compensation professionals must look at multiple types of measures for various roles in the company. This is further complicated when factoring in commensurate incentives across geographic and regulatory boundaries.

This complexity makes it hard—if not impossible—to keep up with all the potential incentive and regulatory parameters with manual processes and spreadsheets. In large organizations, the process is so complex it is common to find “leakage” in compensation. For example, by the time some businesses get their compensation budgets approved, the compensation pools do not reflect the reality of the staff currently in place.

This can result in:

- Allocating limited compensation budgets to employees who leave shortly after the compensation cycle is complete
- Managers “gaming” the system to keep their compensation budgets the same even after they have lost staff
- Human error in data entry and calculations in spreadsheets
- Unnecessary waste of resources

Building Differentiated Compensation: Five Steps

Creating a strong differentiated compensation program includes five major steps:

1) Strategy
2) Technology Support
3) Tactics and Programs
4) Measurement
5) Communication

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Step 1: Strategy

It might seem to be common sense, but many talent management and compensation initiatives fail to achieve the desired results because implementation starts without a clear sense of the objectives and the success criteria for the project.

A compensation strategy maps the desired company results with the necessary behaviors needed from employees across the company. Once the behaviors are determined, the best combination of rewards is selected to achieve these behaviors. Since the company wants to encourage employees to perform at an extremely high level, the compensation strategy ties to the company’s overall talent management and performance assessment strategy.

If the company strategy is to focus a higher proportion of the compensation budget on top performers and high-potential employees, it is critical to be able to identify this category of employee. This is where many companies encounter substantial barriers. When the performance assessment strategy clearly defines the criteria for high performance, managers and employees have a solid foundation for a clear, consistent, and frequent dialogue about the employee’s progress.

Best-in-class performance management will usually have the following attributes:

- Goals that are aligned throughout the organization. The goals should be SMART (Specific, Measurable, Attainable, Relevant, and Timely) to ensure that employees know exactly what is expected.

- Continuous feedback and dialogue between manager and employee to assess progress against those goals.

- Regular (typically annual or biannual) focal performance reviews that assess the “what” (what did the employee achieve when measured against goals?) and “how” (how did the employee achieve the goals measured against the organization’s values and desired competencies?).

- A talent calibration and talent review process across the entire organization that adjusts for variations in how managers assess performance and brings out potentially hidden high potentials and top performers.

If these pieces are not in place, companies might be managing the performance process by gut feel. This results in a lack of checks and balances and becomes a popularity contest for top talent. This is how “diamonds in the rough” in an otherwise poorly performing team or group might go unnoticed, or underperformers might hide in the glow of superstar colleagues.

The SMART goals portion of the strategy ideally should include the company and employee metrics that are being targeted. Relevant company metrics, for example, might include:

- Revenue
- Sales
- Customer Service
- Quality Statistics
These metrics can apply to the entire company, specific departments or business units, different geographies, or any other relevant segment of employees. For example, American companies typically have global compensation and benefits strategies (100 percent of American companies as opposed to 63 percent of French companies).20

It is obvious that the number of combinations can easily overwhelm the strategy team, so ensuring only the most crucial measurement categories are used goes a long way in making sure that the plans will actually be implemented.

The strategy phase will cover the timing of the performance assessment and compensation management cycles during the year as well as the mix of cash versus noncash incentives. These are typically decisions made very infrequently and represent the company’s general talent management and fiscal philosophies.

Another critical decision is how the compensation philosophy reflects the company values. If a company values a performance-driven culture, the retention of top performers is critical. As a result, the compensation philosophy might be to compensate the role at a higher position compared to the market. This will drive the downstream programs and tactics employed by the compensation team.

Step 2: Technology Support

The entire performance and compensation process should have a strong technology underpinning. Without a strong talent technology platform, companies end up with static goals and performance documents that are not modified based on changing business conditions and are not reviewed until the next performance cycle.

In addition, the talent calibration process relies on a single view of organization talent. Without a technology enabler, talent reviews become a lengthy and costly manual process. The technology is also critical to move the calibrated performance assessment data into the compensation technology process.

Given the extraordinary complexity of global compensation plans, flexible and highly configurable technology is essential to manage the process in a way that enables focus on top performers. The technology should take the “heavy lifting” off of the compensation team with regards to compensation rule definition and editing, employee eligibility, and transparency into process and practice in any organization across the globe.

Considerations for the technology platform should include a review of how compensation rules and calculations are created, edited, and implemented. This will be absolutely critical in order to administer a complex compensation landscape. Additionally, the system should be capable of dynamically calculating employee eligibility. Since employees might be eligible for multiple plans—and it is certain

that employees will transfer between departments and geographies—eligibility can change along with these transitions.

To use metrics from the finance and customer support systems, consideration should be given to whether the compensation system can use the input system to calculate variable pay. For example, if employees are compensated based on financial results for their division, the compensation engine must calculate the proper compensation based on the data passed from the finance system.

![Figure 5](image)

Figure 5. Effective compensation management technology should be designed to handle the increasing level of complexity of all the different existing and emerging compensation plans and tools.

Finally, the company might consider whether the system can accommodate a single consolidated view of compensation budgets. This is a radical departure from the manual spreadsheet-driven process that requires the compensation team to compile multiple disparate spreadsheets. As employees transfer within the organization, leave the company, or get hired, manual processes make it difficult to react and change the budgets accordingly. Because the budgets are a challenge to keep updated, there is a high likelihood of budget leakage, where monies are not controlled tightly and are then not available to use on the top talent.

Many existing systems are limited in that they require companies to standardize their compensation plans, which forces the plans to conform to existing rules. An effective compensation management technology should be designed to handle the increasing level of complexity of all the different existing and emerging compensation plans (variable pay and pay for performance) and tools (such as options, restricted stock units, phantom stock, and short- and long-term incentive plans).

**Key Features of Compensation Planning Systems**

- Global compensation rules library
- Configurable total compensation platform
- Global total compensation budget dashboard
- Integration with performance, goals, and other systems
- Base salary and merit planning
- Incentives and bonus planning
- Equity, stock, and long-term incentive (LTI) planning
- Total rewards statements
Step 3: Tactics and Programs

The next phase of implementing highly differentiated compensation is setting the tactics and programs essential to execute on the strategy. These tactics include making the following decisions:

- Who should be eligible for a bonus or other variable compensation program?
- How are the pivotal roles that influence the company metrics identified and at what percentage of the market pay range are they paid?
- How does the company ensure that an employee’s total compensation including variable plans and equity stays within the market ranges for the role?
- What are actual quantitative targets for the performance metrics?
- What percentage of the compensation plans is based on company versus business unit versus individual performance?
- What percentage of the company’s compensation budget will be set aside for top performers?
- What is the framework for the employee communications strategy?
- What percentage of available equity pool is allocated to top performers and high-potential employees?

The tactics and programs step is essential for performance and compensation conversations to occur. Objective performance discussions between managers and employees are only possible if specific criteria are set. The other outcome of this step is that macrolevel communication can occur to alert the organization as to the incentive targets possible if high performance is achieved.

Step 4: Measurement

The next step for developing a differentiated compensation program is to measure progress for the business and for the individual. As discussed above, a high-performance culture is created by establishing an environment where consistent and frequent discussions about employee performance are held between manager and employee. These discussions help employees correct any performance gaps early enough in the cycle to make sure they can attain the targets for high performance.

Talent analytics and reporting that provide enterprisewide, reliable data is the key to program success and continuous improvement, yet too often lacking. Although 93 percent of respondents to a Taleo Research survey of U.S. human resources (HR) and line-of-business executives consider it important to know the compensation benchmarks by job classification and the distribution of performance ratings
versus compensation, only 55 percent and 51 percent respectively have access to reliable data to inform them.21

The other critical measurement is business performance. Frequent updates from the business units regarding progress against the stated goals help employees understand whether their performance is “moving the needle” on the right metrics.

Step 5: Communication

Communicating to employees the results of the year’s progress against goals—both individual and business—is the final step in creating the differentiated compensation program. Total rewards statements are a useful tool in this process. Top performers will clearly see the results of their work and can compare their compensation with the targets established at the beginning of the process.

This is a critical step because top performers need to see concrete evidence that their differentiated performance resulted in differentiated compensation. And less-impactful performers, likewise, need to clearly understand where they did not measure up.

Nearly one-third of U.K. companies offer either Web-based (18 percent) or paper (12 percent) total rewards statements, and around 4 in 10 companies (38 percent) plan to implement them.22 One Asia Pacific study found that only about one-quarter of respondents offer paper (16 percent) or Web (11 percent) total rewards statements. Notably, the benefits enjoyed by those organizations included improved understanding of the rewards package and its value.23

Pay for Potential

Pay for performance is one approach to retain high-potential employees. However, companies need a strategy to recognize the future contributions that these employees will bring to the organization. Pay for potential ties to an overall talent management strategy in a slightly different way. Where pay for performance requires a tight linkage between performance assessment and compensation management, pay for potential also adds succession planning and employee development.

Calibration is a key component of pay for potential, but is used in a different way in pay for performance:

- Performance calibration is used in the pay-for-performance process to ensure that performance is assessed uniformly across a company.
- Pay for potential requires a more broad calibration process that weaves in competency assessment as well as development activities associated with high potential.

Once the broader talent calibration process is established and implemented, the company should consider what types of rewards might be established for high-potential resources. This could be a prime opportunity to leverage noncash rewards or long-term incentives like equity. Examples of noncash rewards could be advanced education opportunities or other types of development activities.

Equity and other longer-term incentives are an attractive option due to the typical vesting timeframes. Employees remain engaged and are incented to perform at a high level to reap these longer-term rewards. These types of rewards—in conjunction with the opportunities for advancement—are significant differentiators compared with employees assessed as average.

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Differentiated Compensation in Action: A Case Study

A large global financial services organization based in Canada with approximately 45,000 employees created an overarching talent management strategy that included a heavy focus on performance-driven rewards. This company had a single, end-of-year performance and compensation cycle.

The requirements for the implementation system started with a focus on differentiating compensation for top performers, with a secondary focus on streamlining the overall compensation process. The company selected an MBO-based bonus structure accompanied by variable pay and equity plans based on company and business unit targets. The added complexity in this structure was that the differentiated rewards had to be applied across multiple geographies and multiple currencies.

A key part of the successful implementation was the change management associated with getting line managers to engage in the conversations necessary to objectively assess performance, and then calibrate the assessments across the globe. The technology solution selected allowed the company to easily apply the rules that were created around the multiple plans.

The results exceeded the company’s expectations. Employees saw an immediate shift in the company toward a high-performance culture. Rewards were differentiated to focus a higher share of the compensation budgets toward the identified top performers and high-potential employees. As a result, the company saw a significant increase in retention of these employees. Additionally, the company confirmed a 20,000-hour savings in resources when they eliminated their manual processes.

Conclusion

In a world where traditional compensation, layoffs, and bonuses make headlines and are becoming increasingly scrutinized and transparent, companies cannot afford to increase their risks in this area. Smart performance-linked differentiated compensation can make the difference between keeping star players and driving powerful company performance or diluting your company’s talent pool and its ultimate impact on the market.

Companies can ensure they take advantage of the best talent insurance available by focusing executive-level time and attention on compensation philosophy and strategy, acquiring reliable market pay data, hiring a top-notch compensation team, training managers to execute on the compensation rules, and putting the right technologies in place.

Blending creative cash and noncash incentives and disproportionately distributing them to your highest performers and highest-potential employees is not only good talent insurance, it is good business.