Is Pay for Performance Possible?
Today’s Speakers

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Context

Point/Counterpoint!

Rethinking Pay for Performance
Context for Today’s Discussion

- Rewards are capable of motivating performance
Rewards Are Capable of Motivating Performance

- High performers are attracted to companies that pay for performance and recognize their contributions
- High performers will leave companies that do not reward performance
- Low performers will self select out of organizations that emphasize high performance in rewards
Context for Today’s Discussion

- Rewards are capable of motivating performance
- Every organization claims pay for performance as an objective
Our Compensation Philosophy

Our Compensation Philosophy

Our compensation programs should support a short- and long-term business focus, be flexible to accommodate changes in business direction, and create a performance-based culture. The compensation programs should create and reinforce strong line of sight by:

- Rewarding for results;
- Aligning risks and rewards; and
- Attracting and retaining valuable employees within a market competitive rewards framework.

The compensation programs should be objective, defensible, and consistent with our values.
Context for Today’s Discussion

- Rewards are capable of motivating performance
- Every organization claims pay for performance as an objective
- Employers are dissatisfied with their ability to accomplish pay for performance
Increasing Dissatisfaction With Ability to Achieve Pay for Performance

How Successful Is Your Company’s Program in Differentiating Pay

Source: Hewitt Associates Survey Findings of Update on Compensation Planning for 2011, November 2010

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Context for Today’s Discussion

- Rewards are capable of motivating performance
- Every organization claims pay for performance as an objective
- Employers are dissatisfied with their ability to accomplish pay for performance
- Surprisingly few organizations are truly achieving pay for performance
Differentiating Pay Based on Performance

How Effective Is Your Company’s Program in Differentiating Pay Based on Performance

Source: Hewitt Associates Survey Findings of Update on Compensation Planning for 2011, November 2010

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Context for Today’s Discussion

- Rewards are capable of motivating performance
- Every organization claims pay for performance as an objective
- Employers are dissatisfied with their ability to accomplish pay for performance
- Surprisingly few organizations are truly achieving pay for performance
- It is not the intent—but rather the execution
What Are the Obstacles to Pay for Performance?

- Insufficient funding
- Skewed performance distributions
- Faulty goal setting—no clear definition of “performance”
- Unrealistic employee expectations
- Poor modeling by executives
- Only strong performers remain
- Manager skills
- Reluctance to drive differentiation
- Lack of consequences
- Emphasis on the wrong components of rewards
Context

Point/Counterpoint!

Rethinking Pay for Performance
There Is Insufficient Funding to Differentiate Pay Based on Performance

**Point**
There is not enough money to pay for performance

**Counterpoint**
Differentiation can still occur with decreased funding
Companies View Merit Pay as the Means to Differentiate Performance

Approaches Being Used

- Merit Pay: 82%
- General Increases: 6%
- Carve Outs: 4%
- Lump Sums: 2%
- Variable Pay in Lieu of Base: 2%

Perceived Effectiveness

- Merit Increases: Very Effective
- Short-Term Incentives: Effective
- Long-Term Incentives: Effective

Source: Hewitt U.S. Salary Increases 2010/2011
U.S. Salary Increases (1990–2011) Are at an All Time Low

Source: Hewitt Salary Increase Survey 1990-2010 and Overall Salary Increase Budgets for Salaried-Exempt Employees

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Managers and Employees Are Skeptical That Pay Differentiation Is Possible

- There is not enough money to truly differentiate performance
- Another 1% is not going to do much—you can be more effective through bonuses
- We have managed out all our low performers
- Why should I bust my hump for .05%
- I am one of the high performers
- Everyone gets the same no matter how we perform

Manager

Employees

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U.S. Salary Increases (1990–2011) Are at an All Time Low

Source: Hewitt Salary Increase Survey 1990-2010 and Overall Salary Increase Budgets for Salaried-Exempt Employees

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Merit Distribution 20 Years Ago

- Typical distribution of merit increases assuming 8.0% budget
Merit Distribution Today

- Typical distribution of merit increases assuming 2.8% budget
Allocation of Merit Increases by Performance Level (As a Percent of Merit Budget)

<table>
<thead>
<tr>
<th>Performance Level</th>
<th>20 Years Ago</th>
<th>Today</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low</td>
<td>40%</td>
<td>40%</td>
</tr>
<tr>
<td>Average</td>
<td>90%</td>
<td>90%</td>
</tr>
<tr>
<td>High</td>
<td>120%</td>
<td>130%</td>
</tr>
</tbody>
</table>

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Source: Hewitt U.S. Salary Increases 1990-2009
There Is Insufficient Funding to Differentiate Pay Based on Performance

**Point**
- There is not enough money to pay for performance

**Counterpoint**
- Differentiation can still occur with decreased funding

- Organizations struggle to do it
- Employees and Managers are skeptical
- Money not available
- Significant time investment for little reward

- Focus on where differentiation is possible
- Shift time to where it makes a difference
- Recognize limitations of management

- Differentiation can always occur
- Organizations need discipline
- Managers need tools
- Employees need contributions valued

- Do what is right; not avoid what is difficult
- Focus on how to allocate not what
- Educate and communicate how it is done
Organizations are Better Served Investing Dollars in High Performers as Opposed to Trying to Move the Middle

**Point**
Strong emphasis on rewarding top performers

**Counterpoint**
Drive improvement from the middle
Focus on High Potentials and High Performers

Current Efforts to Address Top Talent

<table>
<thead>
<tr>
<th>Description</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>55% of organizations track high potentials</td>
<td></td>
</tr>
<tr>
<td>47% of organizations track high performers</td>
<td></td>
</tr>
</tbody>
</table>

How Merit Dollars are Distributed

<table>
<thead>
<tr>
<th>Description</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>All pay to high performers</td>
<td>1%</td>
</tr>
<tr>
<td>Majority to high performers, some to average, and none to low performers</td>
<td>29%</td>
</tr>
<tr>
<td>Some to each group with greatest portion going to high performers</td>
<td>58%</td>
</tr>
<tr>
<td>Equally distributed</td>
<td>6%</td>
</tr>
</tbody>
</table>

Use of separate merit budget for high potentials/top performers 5%
Focus on High Potentials and High Performers

Reduced High Performance Turnover


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Focus on High Potentials and High Performers

Relative Economic Service Value


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The Middle Encompasses the Largest Part of Our Population

Greatest Leverage on Results Comes From the Middle

The impact from a small gain in productivity or contribution from 60% of the workforce far exceeds the gain from the 25% of the workforce considered top performers.
By Focusing on the Middle
We Can Expect Stronger Productivity Gains

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Organizations Have the Opportunity to Focus Compensation Programs to Drive Middle Performers to Top

Create a model to dissect the middle into categories and create targeted programs

<table>
<thead>
<tr>
<th>Performance</th>
<th>Developing/Below</th>
<th>Solid/Good</th>
<th>Amongst Highest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pay position above market</td>
<td>Position at or below market</td>
<td>Pay position at or above market</td>
<td>Pay position above market</td>
</tr>
<tr>
<td>Annual increase above target (depending on position)</td>
<td>Annual increase at target (depending on position)</td>
<td>Annual increase at or above target (depending on position)</td>
<td>Annual increase above target (depending on position)</td>
</tr>
<tr>
<td>Above target earnings</td>
<td>Above target earnings</td>
<td>Above target earnings</td>
<td>Above target earnings</td>
</tr>
<tr>
<td>LTI Consideration</td>
<td>LTI Consideration</td>
<td>LTI consideration</td>
<td>LTI and Recognition eligible</td>
</tr>
<tr>
<td>Development plan</td>
<td>Development access/Promotion planning</td>
<td>Recognition eligible</td>
<td>Promotion consideration</td>
</tr>
<tr>
<td>Promotion consideration</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Position below market</td>
<td>Position below market</td>
<td>Position below market</td>
<td></td>
</tr>
<tr>
<td>No to limited increase</td>
<td>No to limited increase</td>
<td>No to limited increase</td>
<td>Limited increase</td>
</tr>
<tr>
<td>Pay less than target</td>
<td>Pay less than target</td>
<td>Pay less than target</td>
<td>Pay less than target</td>
</tr>
</tbody>
</table>

Growth Potential

- Well Placed
- Typical
- Accelerated

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Organizations are Better Served Investing Dollars in High Performers as Opposed to Trying to Move the Middle

**Point**
Strong emphasis on rewarding top performers

**Counterpoint**
Drive improvement from the middle

- Retaining top talent is critical
- Economic cost associated with top talent loss
- Retention of top talent outweighs loss of lower
- Difficult to be all things to all people—focus

- Identify high potential and high performers
- Focus funds and programs on top first
- Communicate benefits and value of being top

- Rewarding top performers is limiting
- Greatest improvement comes from middle
- Targeted programs can improve success
- Significant economic gain if done right

- Define target middle population
- Prioritize priorities and build programs
- Set clear goals and measures results
Rewarding Company Performance Drives a Better Outcome Than Measuring at Lower Levels in the Organization

**Point**
Reinforcing Company performance aligns employees with the business

**Counterpoint**
Company performance alone cannot effectively drive individual behavior
Rewarding Company Performance Drives a Better Outcome

- Advantages of focusing on Company performance:
  - Supports collaboration and teamwork versus competition and sabotage
  - Difficult to cascade goals and metrics lower in the organization
  - Avoids winners and losers
  - Creates an enterprise-wide focus
Many mechanisms available to reward for company results:

- Cash profit sharing 15%
- Team awards 18%
- Special recognition awards 52%
- Gainsharing/productivity awards 10%
- Stock options/ownership 38%

*Source: Hewitt Variable Compensation Measurement Database 2010/2011*
Best-in-Class Organizations Create a True Performance-Driven Culture

“Where are we going? Why are we going there”

Performance Driven Culture

- Common understanding of the organization’s priorities and goals
- Performance Planning
- Rewards & Development
- Coaching and Feedback
- Performance Review
- Commitment based on meaningful work and rewards
- Clear expectations for individual and group contributions
- Capability built through feedback and coaching

“What’s in it for me?”

“How will I succeed? How do I know if I am successful?”

“Where are we going? Why are we going there?”

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Companies Can Use a Variety of Approaches to Effectively Align Goals and Measure Results

Corporate Balanced Scorecard

- Financial
- Customer
  - Business Processes
  - Learning and Growth

Divisional Scorecard + Individual KPIs

- Financial
- Customer
  - Business Processes
  - Learning and Growth

Divisional Scorecard + Individual KPIs

- Financial
- Customer
  - Business Processes
  - Learning and Growth

Individual Performance Goals

Scorecard Adapted from Robert S. Kaplan and David P. Norton

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Many of the Factors That Drive and Hinder Program Effectiveness Are Linked to Lack of Control and Impact

- **Drive Success**
  - Support of executives/management
  - Realistic Goals/Targets
  - Employee understanding
  - Effective communication of plan
  - Appropriate award sizes
  - Employee ability to impact results
  - High employee commitment/participation
  - High-Level Champion

- **Hinder Success**
  - Payouts viewed as entitlement
  - Lack of employee participation
  - Poor communication
  - Plan design too complex
  - Employees little ability to impact results

*Source: Hewitt Variable Compensation Measurement Database 2010/2011*
Rewarding Company Performance Drives a Better Outcome Then Measuring at Lower Levels in the Organization

- Point
  Reinforcing Company performance aligns employees with business

- Counterpoint
  Company performance alone can not effectively drive individual behavior

- Company focus creates stronger alignment
- Organization view unifies employees
- Communication is clear and straight forward
- Easier to define and design reward metrics

- Avoid having winners and losers
- Seek appropriate reward mechanisms
- Focus critical corporate measures
- Engage leaders in program

- Company performance one-dimensional
- Employee connection to results limited
- Clear line of sight non existent
- Broader view builds stronger connections

- Seek opportunities for closer line of sight
- Confirm appropriate levels of performance
- Engage managers in solution
- Align compensation programs
Providing Merit Increases Is the Only Meaningful Way to Provide Pay Differentiation

**Point**
Merit is the most important pay lever

**Counterpoint**
A broader view on compensation can generate greater return
Merit Is the Most Important Pay For Performance Lever

Base Salary

Benefits

STI

LTI
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Merit Is the Most Important Pay For Performance Lever

- A base salary increase is the primary means to reflect the value of the job
- Employees place significant value on an increase in base salary and historically have come to expect an annual bump in pay
- Salary levels are still the primary standard of comparison in recruiting
- Other employee values are calculated based on salary levels
Companies Are Shifting Investments to Other Compensation Levers

Variable Pay Awards for Salaried Employees (as percentage of payroll)

Source: Hewitt U.S. Salary Increases 1990-2011

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There Is a Dramatic and Ongoing Shift in Pay Mix That Has Been Taking Place

Change in the Total Compensation Budgets and Spending for Salaried-Exempt Employees (1991-2010)

- 1991:
  - Overall Base Salary Increase Budget: 5.0%
  - Variable Pay Spending: 3.8%

- 2010:
  - Overall Base Salary Increase Budget: 11.3%
  - Variable Pay Spending: 2.4%

*Source: Hewitt U.S. Salary Increases 2010/2011*
A More Holistic View of Pay for Performance Provides Flexibility to Use Different Program Types to Reward Results
Proving Meaningful Merit Increases Is the Only Meaningful Way to Provide Pay Differentiation

**Point**
Merit is the most important pay lever

**Counterpoint**
A broader view on compensation can generate greater return

- Merit increase is the gold standard
- Employees value salary increases the most
- Employees expect annual salary increases
- Other rewards are based on salary level

- Focus on how to make merits meaningful
- Get creative
- Arm managers
- Communicate merit approach

- Merit only programs are limiting
- Not enough money for meaningful change
- Broader view provides flexibility
- Programs can work in tandem to drive results

- Seek broader view of compensation
- Create compensation strategy
- Get creative
- Test effectiveness

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And the Winners Are………………………………………

Pay Differentiation
- It is not the amount of funding but how it is allocated
- Leaders must commit to the effort
- More communication and training is needed

Focus on High Performers
- Greatest economic value from top performers
- Retaining top talent outweighs turnover concerns of low performers
- Focusing on the middle is often too broad and not easily targeted

Drive Multi-Level Accountability
- Line of sight is critical in focusing behavior
- Multi-tiered measurement and rewards yield better business results
- Corporate centric plans align employees but do not engage them

Consider a Broader View on Compensation
- Line of sight dominates the pay for performance landscape
- Variable pay is a great tool to link pay and performance
- Consider monetary and non-monetary elements to motivate behavior
- Context
- Point/Counterpoint!
- Rethinking Pay for Performance

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Rethinking Pay for Performance

- Pre-requisites for achieving pay for performance:
  - Managerial capability
  - Comprehensive and ongoing communications
  - Effective performance management system
  - Leadership commitment, reinforcement, and accountability
Rethinking Pay for Performance

- Match type of reward approach to desired outcome:
  - Greater variability in business results ==> less variable compensation
  - Unstable objectives ==> significant variable compensation
  - Need for high productivity and cost control ==> individual performance focus
  - Need for collaboration and teaming ==> group oriented mechanisms
Rethinking Pay for Performance

- Re-think the roles of rewards components
  - Merit increases based on competitive value for requisite skills
    - Carve outs
    - Lump sums
    - Extended timing reward cycles
  - Variable pay with strong line of sight
    - Heavier reliance on individual performance elements
  - Broaden our definition of “reward”
    - Monetary and non-monetary rewards
How To Contact Today’s Speakers

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