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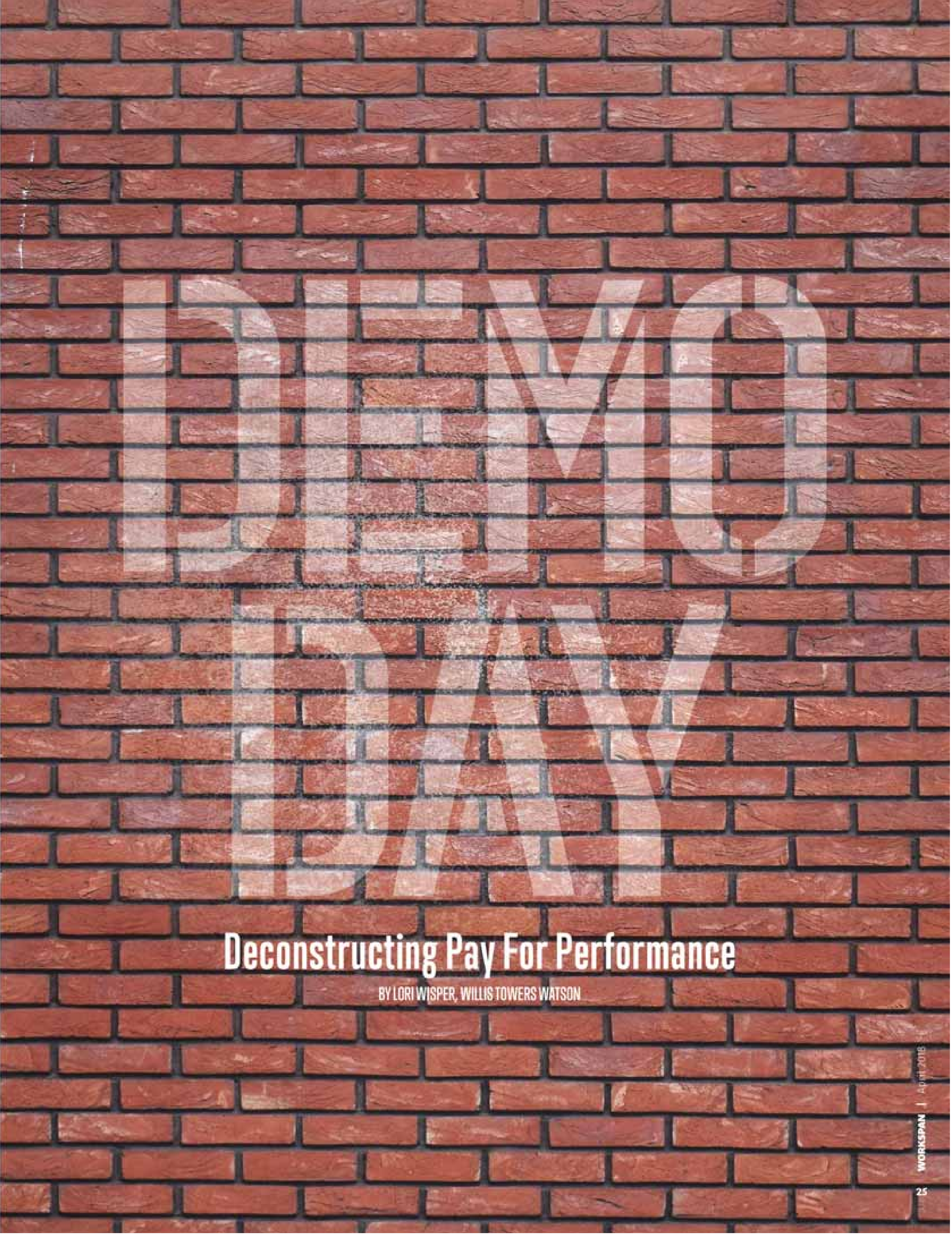

DEMO DAY

Deconstructing Pay For Performance

BY LORI WISPER, WILLIS TOWERS WATSON

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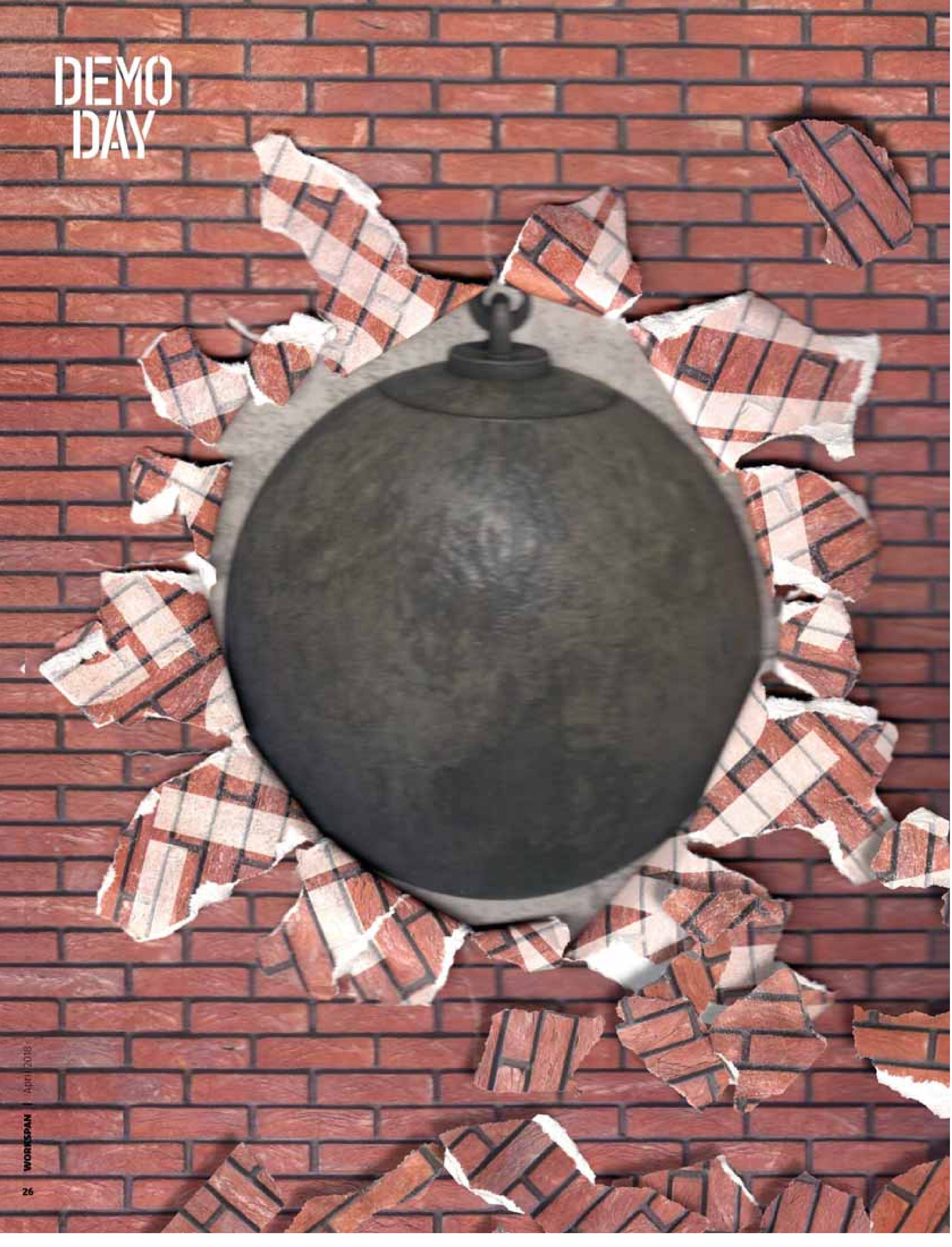


House renovations typically are a painful experience. They take months of careful planning and creative design thinking, and the construction process is a combination of hard labor and fortitude. And if you watch any of the reality TV renovation shows, you know that the "big reveal" is going to show something so great, it hardly resembles the old house.

While this article won't extoll the benefits and challenges of renovating a house, the deconstructing and rebuilding process is an appropriate analogy to examine and address the issues plaguing the pay-for-performance process in many organizations today.

First, let's ask a key question: "Why now?"

Well, most of you have heard about the companies that have eliminated, or are considering eliminating, performance ratings to change how employees experience the performance management process. Throughout this debate, pay-for-performance issues and challenges almost always surface, making it a perfect time to really examine and deconstruct the process as you work to rebuild and improve it.

Regardless of whether your organization is considering going (or has already gone) ratingless, the deconstruction and rebuilding of pay for performance should lead to a better way to align performance with rewards, and ultimately help shape the overall employee experience.

DEVELOP YOUR BLUEPRINT

All successful renovations start with a blueprint. In home construction, the blueprint provides guidance on how to design a house to get the desired outcome. As such, it's also a great first step in pinpointing the weaknesses of the current design, enabling the deconstructing and reconstructing of it.

Similarly, a blueprint in the form of a pay-for-performance strategy also is a great way to both assess the process you have in place as well as determine what's needed to make it better. The building blocks of this strategy include the guiding principles for change to define what success looks like. (See "Example of Pay-for-Performance Guiding Principles.")

The overarching foundation of the pay-for-performance strategy is to first define what we even mean by "performance." As strange as it may sound (doesn't everyone know what performance

EXAMPLE OF PAY-FOR-PERFORMANCE GUIDING PRINCIPLES

Pay for performance at our company will be:

- Highly visible and held accountable by all leaders and managers
- Executed consistently across the various businesses
- Aligned with a defined set of performance definitions, reward vehicles and expectations for employees
- A connection between goals and strategy and performance and development
- Energizing and meaningful to employees so they feel that they are truly rewarded based on their performance
- A process that employees are engaged in and involved with (in addition to managers)
- Inclusive of simple tools to facilitate dialogues and make pay decisions
- Inclusive of more frequent feedback and dialogue
- Supported by clear messaging, communications and education/training
- Analyzed through increased data analytics to better understand levels of performance and productivity.

Figure 1 | **The Bigger Picture of Performance**

	HR'S VIEW		MANAGER'S VIEW
	Factor should affect	Manager gives more weight than intended	Factor does not affect their decision
Final rating in most current year-end performance review	72%	52%	63%
Achievement of individual goals	65%	47%	65%
Demonstration of knowledge and skills required in current role	55%	41%	68%
Penetration in pay range for current role	54%	30%	57%
Achievement of team goals	49%	29%	66%
Concerns over market competitiveness	48%	37%	55%
Possession of skills critical to the success of the future business model	46%	40%	63%
Criticality of the role	48%	54%	62%
Concerns over internal equity	42%	44%	52%
Perceived potential	41%	41%	59%
Demonstration of company values	35%	19%	57%

means?), this is at the heart of making this rebuild different from others your organization may have tried in the past.

Many organizations focus more on the process rather than the core issues when tackling performance management and pay for performance. How many times has your organization debated whether to have three, four or five ratings? How many times have you "improved" your performance review form, added new technology, changed the forced distribution guidelines (or "unforced" them and just called them guidelines)?

While all of these changes can bring incremental improvement, the opportunity for real improvement — meaning improved performance, not only improved process outcomes — comes from getting *focus and clarity.*

SET THE FOUNDATION: DEFINE PERFORMANCE

Focus and clarity are the end game. How do we give managers clarity on exactly what performance to reward and provide focus to everyone on what they need to do to get rewarded? It may be as simple as thinking of the statement, "If you as an employee do X, we as the employer will give you Y."

If our pay-for-performance process could be that clear, employees would not only know what to do to get rewarded, they also would know what they didn't do and, therefore, why they didn't get rewarded (which is how differentiation works).

The desired outcome of any effective pay-for-performance process is to reward the right type of performance in order to maximize and continue it in the future. As such, it's critical to provide clarity on how performance is defined in the current pay-for-performance process. For many organizations, performance typically is taken from the

The desired outcome ... is to reward the right type of performance.

performance management program and referred to as "the what" and "the how." The what and the how most often mean the goals that are set in a performance period, typically annually, and how an employee goes about achieving those goals.

While there is absolutely nothing wrong with defining performance this way, most of the time the what and the how aren't all that an organization expects from employees. If you were to make a list of all the expectations you have for employees, it would undoubtedly include other things such as:

- Living the values of our company
- Collaboration and teaming
- Exerting discretionary effort.

And what about the job the employee was hired to do? Where does that fit into our definition of performance? Perhaps some of the job-related duties show up in goals? Maybe, however, many organizations tell managers to write goals that are "above and beyond" what is expected on the job.

If we're being honest, most organizations fail to provide clarity and focus when defining performance. Managers tend to think of performance more holistically than just the what and the how, as we learned in the Willis Towers Watson research shown in Figure 1. If the performance management process is instructing managers to rate employees based on the what and the how and they tend to think of performance as broader, it is not surprising that they're frustrated when they can't effectively reward employees who they think are meeting their expectations in a broader way.

How can we, as total rewards professionals, provide greater clarity on the definition of performance? If we first think of it as more holistic, as managers tend to, everything the organization expects from employees should be considered. Then, we can determine exactly which elements of performance we should pay for by aligning each with an appropriate rewards vehicle. For example, we can more specifically define individual employee performance as shown in Figure 2.

By taking a scalpel to defining performance using the three categories — job-based, goal/time-based and future potential-based — we more transparently outline all expected outcomes of individual employee performance. Then, we can more effectively align outcomes with different rewards elements to provide managers with clear and focused guidelines on how to pay for performance.

RECONSIDER PAY ELEMENTS AND ALIGN PURPOSEFULLY WITH PERFORMANCE

Once the clear definitions of performance are established as a foundation, aligning each with the appropriate pay (or rewards) vehicle becomes a very logical exercise. For example, when you consider the job-based performance definition, it's logical to think of the value of a job being most typically expressed in base salary terms. Therefore, it seems logical to tie base pay and base pay increases to job-based performance.

And, to be clear, this is not meant to be a general or cost-of-living increase. Job-based performance should still be considered performance! If your organization has used the term performance to narrowly focus on goals managers set for employees and how they achieve them, to now include the more basic element of job-based performance may seem foreign. The comment, "Why should we pay for that when it's just about doing the job?" may be heard, or even, "That's just about retention. Why should we pay for someone just showing up every day?"

While the objective is not to lower the organization's performance standards, isn't retention also important? Why wouldn't an organization want to pay for retaining employees? And, while it's certainly not about just showing up, retention is usually considered baseline to higher levels of what we typically think of as performance. So, it makes sense to at least start there.

To provide clarity and focus by more definitively outlining performance and aligning pay to each definition, we can give managers different tools to reinforce what's important and have a more meaningful pay-for-performance conversation with employees. Figure 3 illustrates how the alignment works.

Notice that the what and the how is still an important element of performance and both need to be part of the pay-for-performance framework. But, as you can see from this illustration, it's not the only element. And it's more focused by aligning with a pay vehicle, such as short-term incentives (STIs), because this definition of performance is variable and time-based — as are STIs.

DEVELOP EFFECTIVE DECISION TOOLS FOR MANAGERS

One of the most common complaints about pay for performance failing to effectively reward the best performers centers on managers being unable to differentiate pay decisions. As total rewards and HR professionals, we often are frustrated by how disengaged managers are — even when we think we trained them on how to do this more effectively. Again, if we examine our current processes (and training) with

Figure 2 | **Defining Individual Employee Performance**

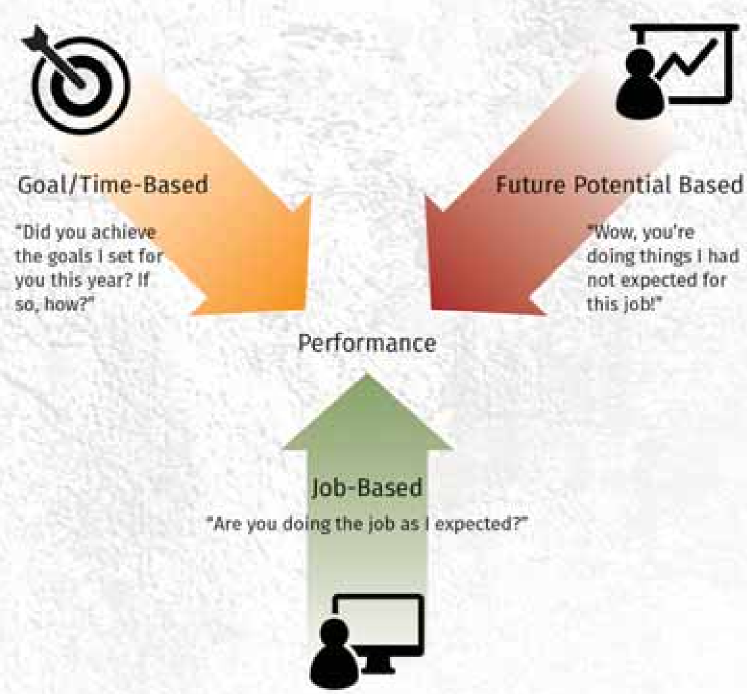
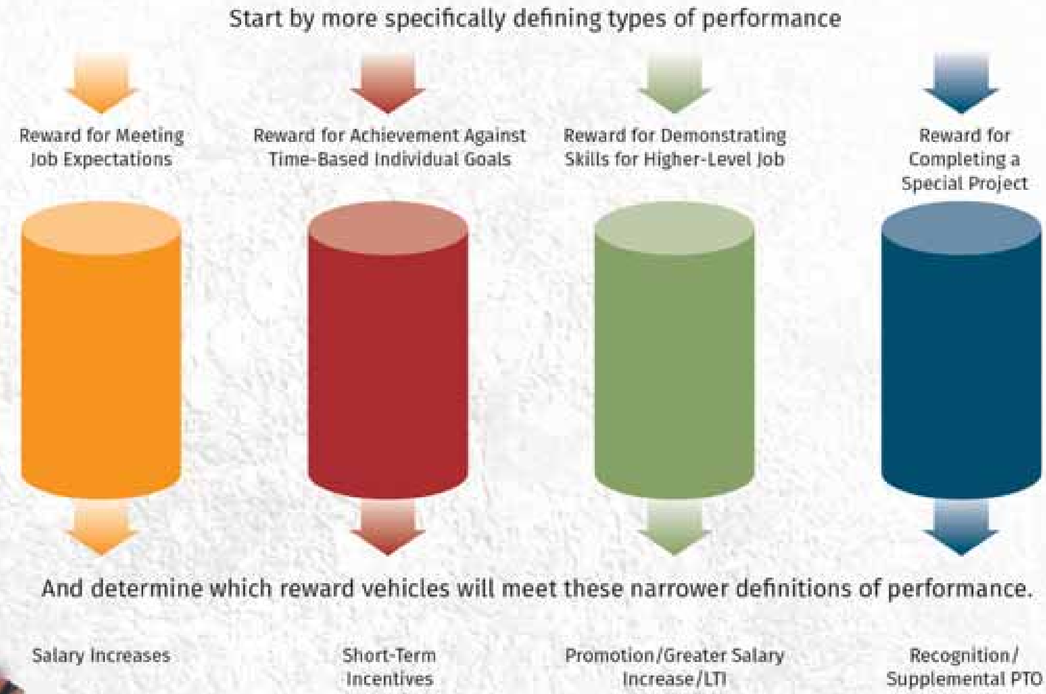


Figure 3 | **Align Each Performance Element with a Rewards Vehicle**



an eye to whether they provide clarity and focus, we might also find that the decision tools we provide to managers are lacking.

For most organizations, merit pay is still the top choice to pay for individual employee performance. In fact, in a recent WorldatWork virtual course on the topic, close to 70% of attendees said that base pay or merit increases were their primary pay-for-performance vehicle. And most also still use either a merit matrix or merit guidelines, which give the same direction as a merit matrix but without the matrix. And what, exactly, is a merit matrix? It's a decision tool that you hand to managers that says, "Use this to decide what type of increase to give each of your employees."

The merit matrix was first introduced in an American Compensation Association (now WorldatWork) certification manual in the mid-1970s. While easy to use and efficient, we have to decide whether the merit matrix is still effective in directing managers to make the best pay decisions.

In essence, the merit matrix is a one-dimensional decision tool (because the performance rating already is determined before using the merit matrix) that takes "position in range" (or how base pay compares to a market point) into account. Market comparison to current base pay levels is important, no doubt. But HR often also reminds managers to take into account many other considerations, for example:

In essence, the merit matrix is a one-dimensional decision tool that takes 'position in range' into account.

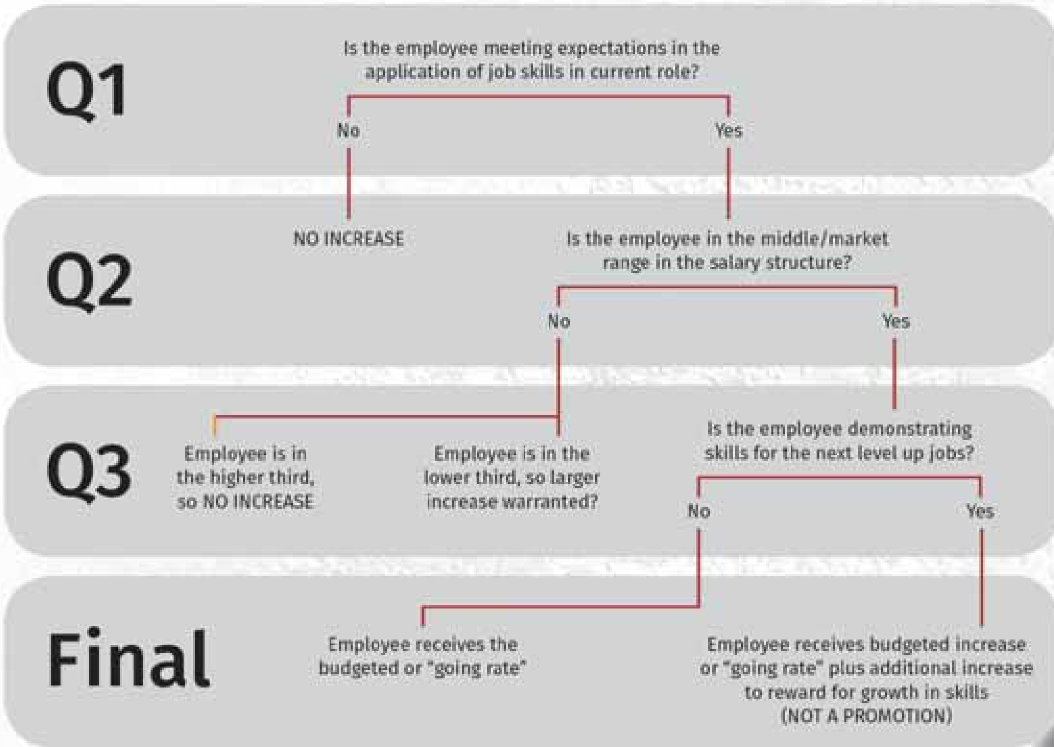
- Is the employee in a "hot skill" job?
- Is the employee a high potential?
- Has the employee had sustained performance over time?
- Is the employee new to the role and still learning?

Developing effective decision tools for managers probably means taking a sledgehammer to the merit matrix and determining what will work now. Regardless of whether your organization has gone ratingless, you can improve your pay-for-performance outcomes by developing decision tools for managers that guide them to make multidimensional pay decisions with much better outcomes.

A decision tree is one such tool. Its structure asks a question and provides a "yes" or "no" answer. If the

Figure 4 | **A Better Way to Guide Managers?**

An illustrative salary increase decision tree, baseline.



answer is yes, the reader goes on to the next question. If the answer is no, there is guidance on how to make the decision.

Developing a base pay increase decision tree can provide managers with guidance in the same way: by asking a series of questions and giving guidance about considerations for making the appropriate salary increase decision. There are some elements of this decision tree that likely will be the same or similar for all organizations, and some that will be distinct to your organization based on your compensation philosophy, career development philosophy, culture and other factors.

The example in Figure 4 is a baseline version of this and doesn't include any of those unique elements that an organization could add to make it singular to them.

REBUILD TO MODERNIZE

As in most renovation projects, organizations should look to deconstruct and rebuild their pay-for-performance process to make it more current. That means understanding today's environment and redeveloping the process to better address it. For example, if you're still using a merit matrix to provide guidance to managers, remember that when the merit matrix was developed, salary increase budgets were in the double digits. In the United States and other developed countries, we're unlikely to get much beyond 3% to 4% in the coming years.

Modernizing pay for performance also means taking your audience into account. Employees today want to be treated more as consumers of your employee value proposition. As such, the way that you reward them for their side of the employment deal can be a critical part of that consumer-grade experience. Given the variety of generations that now compose this audience, taking employee's rewards preferences into consideration could be a very powerful way to make this experience come to life.

Factor in social media, digital employee portals and crowdsource feedback (think number of "likes"), and you have a completely different employee experience. Modernization may also mean looking beyond the traditional compensation elements to include many different types of rewards that employees really value. Once you start down this path, the possibilities are exciting. Using your pay-for-performance process to create a "moment that matters" could significantly improve the overall employee experience. Ready for your demo day? ws

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