



Five keys to getting compensation right

Paying for what matters in the new world of work

In today's rapidly evolving work ecosystem, compensation programs must meet a growing range of often conflicting objectives from market competitiveness to pay fairness, resulting in a complex decision-making process that requires greater use of technology.

This and other findings from the Getting Compensation Right Survey reveal the scope of the task confronting employers as they attempt to optimize their limited compensation budgets and communicate the results in a highly dynamic global work environment. In response, organizations are starting to think carefully and deliberately about what it is they're paying for and why. Many are taking a more future-focused approach to performance management and compensation decisions. At the same time, issues of pay transparency and equity are gaining traction globally, all of which are prompting organizations to take a broader view of their pay practices.

This research aims to provide a deeper understanding of the current state of pay programs globally, employers' plans over the next three years and the best practice breakthroughs essential to getting compensation right.

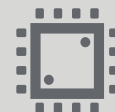
Our findings examine five elements critical to developing relevant, high-impact compensation programs.



Identify the factors that determine base pay



Improve differentiation of incentives



Make effective use of technology



Prioritize fair pay



Build a culture of pay transparency



1 Identify the factors that determine base pay.

The issue: Base pay is not effectively driving performance.

It's time to rethink merit pay, the mainstay of traditional compensation programs. Less than half of employers (44%) say that base pay programs are effective at driving higher individual performance. In fact, one out of four strongly disagree with this statement. And 63% of employers indicate that limited budgets are a challenge to reflecting performance in merit pay.

A closer look at the factors used to determine base pay reveals a complex decision-making environment with many organizations reporting that six or more factors affect base pay increases to a great extent. These findings suggest that some companies may be considering too many factors in making certain pay decisions and that the role of base pay needs to be redefined for today's changing workplace. While employers understandably need to take into account a range of factors in determining base pay, they will likely not be able to consider all factors to the same extent for all employees.

Currently, employers focus primarily on the achievement of individual goals, final rating at year's end and market competitiveness when deciding pay increases (Figure 1).

Some companies may be considering too many factors in making certain pay decisions. Our findings suggest that the role of base pay needs to be redefined for today's changing workplace.

Figure 1. Organizations are operating in complex environments when it comes to factors affecting base pay decisions.

To what extent does each of the following factors affect individual employee base pay increases in the current design?



While market competitiveness will continue to remain a key factor in pay decisions over the next three years, there will also be a stronger focus on skills critical to future success and future potential.

Interestingly, as many of these determining factors become more important in the next three years, few of today's determining factors will become less important, adding to the complexity of making pay decisions. However, we are seeing a decline in the relative importance of using the prior year's performance to determine future pay (Figure 2).

Consider how these findings play out across key areas:

- **Current versus future requirements.** As employers confront shifting requirements in the new world of work, a greater emphasis will be placed on possessing the skills necessary to achieve future business objectives.

While 60% of employers report that demonstration of knowledge and skills required in the current role influences base pay increases to a great extent today, over half (51%) say that possession of skills critical to the future business model will become more important over the next three years. But at the same time, 76% also say that knowledge and skills required in the current role will remain just as important going forward as they are today, highlighting employers' competing priorities.

As companies adopt a more future-focused approach to pay programs, perceived potential grows in importance with roughly a third of employers (31%) indicating that this factor will become more important over the next three years. Moreover, organizations must use appropriate tools and robust methodologies to document the measurement and impact of potential on pay in order to ensure this factor doesn't have an adverse effect on the pay of women and minorities due to incorrect subjective perceptions of potential.

- **Market competitiveness.** Reflecting a tightening labor market, market competitiveness is and will continue to be a critical factor in making pay decisions. At present, market competitiveness is a key factor for nearly two-thirds of employers. Over the next three years, 47% indicate that this factor will become even more important.

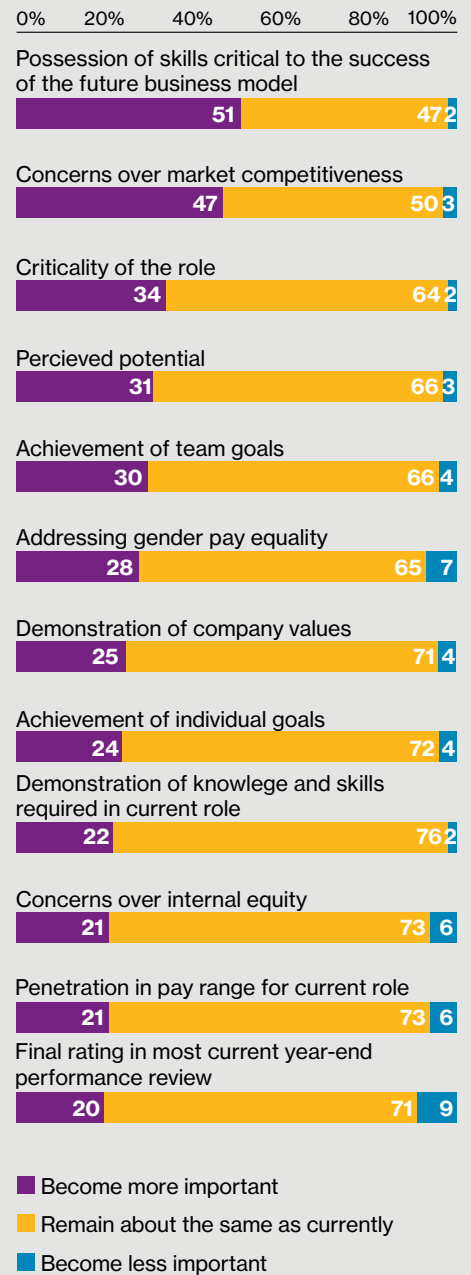
- **Gender pay equality.** While it's critical that organizations pay all employees fairly relative to the market and each other, gender pay gaps merit special attention.

At present, almost one-quarter of organizations globally say that gender pay equality is a key factor in making base pay decisions (23%), and 28% say it will grow in importance in the next three years.

At the individual country level, while 20% of employers in the U.S. and 34% in the U.K. report that gender pay equality *currently* influences pay increase decisions to a great extent, in these countries, 41% and 58% of respondents say gender pay equality will grow in importance over the next three years.

Figure 2. **Base pay decisions will only get more complex as emerging, future-focused factors become more important.**

How will the importance of each of the following factors on individual employee base pay increases change over the next three years in the design of your base pay programs?



In addition, other often competing priorities, such as the importance of individual versus team goals and flexible versus rigid 12-month review cycles, add to the complexity of making pay decisions to varying degrees.

Facing an increasingly complex decision-making process, roughly 40% of organizations are planning on or considering changing the criteria for merit increases.

Breakthroughs that matter!

Clearly define the role of base pay.

To define the role of base pay, it's essential to identify the mix of key factors that will guide an organization's decision making. The extent to which an organization can differentiate pay using a range of factors will depend largely on its budget.

- In organizations with tight merit budgets, such as those in low-inflation countries, it's critical to segment – that is, divide employees into different groups using such variables as critical skills, future potential and team/network – and simplify by reducing the number of factors that should determine base pay for each of these different groups.

For instance, some organizations might be paying certain groups for future potential instead of rewarding last year's performance. For other groups, current contribution might be the key determining factor.

- Organizations with more substantial budgets may decide that having a larger mix of determining factors will improve the effectiveness of their base pay programs. In fact, our research shows that companies that perceive their base pay decisions as effective are more likely to take into account a wider range of factors in determining merit increases.

But for these options to work, companies must invest both in the tools that will support a complex decision-making process and in equipping managers to understand their role in the process.

What are employers' top challenges in delivering effective pay for performance?

Limited budgets

63%

Manager capability

44%

Limited differentiation

42%



2 Improve differentiation of short-term incentives.

The issue: Employers miss opportunities to differentiate incentive payouts to top performers.

Though many companies have more than one form of short-term incentive program, the two most prevalent types are the organization-wide incentive (62%) and the individual incentive (53%). The average funding level for the largest plan in each company (i.e., the plan with the most employees) for the most recently completed fiscal year was below 80%, which is in line with past findings.

Organizations are missing opportunities to increase top performers' incentive differentiation. Consistent with our previous research, one-third (33%) of companies pay incentives to employees who do not meet expectations. Organizations intend to pay top performers about 20% above target when funding levels are normal/on target, and in those situations, they are generally doing so. However, our findings suggest that when actual funding differs from target funding, incentive payout differences are compressed at the top end.

When actual incentive funding levels fall below target, nearly a third (33%) of employers reduce the payout to top performers by a greater percentage than they do the payouts to other employees and over half (53%) reduce it by the same percentage as for other employees. When payouts are above target funding levels, the payouts to top performers are compressed.

These missed opportunities to differentiate bonuses could help explain why almost half (48%) of organizations are planning or considering changes to the design of their annual incentive plans. We also see that as past performance becomes less of a key factor in base pay decisions, the importance of reflecting this factor in annual incentive plans becomes more important.

Breakthroughs that matter!

Differentiate enough to make it meaningful.

To better allocate finite short-term incentive budgets to high-value talent, decide which positions should have considerable pay at risk and ensure the incentive payouts deliver appropriate upside to the right employee groups.

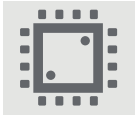
Lastly, once an organization's bonus pool funding level is set, it's important for that organization to review its funding targets at all performance levels to ensure it is optimizing opportunities to reward its top talent.

Recognition programs gain traction



of employers are planning on or considering developing new types of recognition programs.

In addition to their low cost, these programs offer a quick way to support emerging skills and changing workplace practices, and provide immediate, personalized rewards, particularly appealing to employees seeking instant gratification. And these benefits are realized without increasing fixed costs such as base pay.



3 Make effective use of technology to improve decision making.

The issue: Complex pay decisions can become all the more challenging due to inadequate technology.

As companies take more factors into consideration in making base pay and incentive decisions, they need sophisticated technology, data and analytics to support their decision making. The right decision support tools are also critical to ensuring fair pay. But only half of organizations use software beyond spreadsheets to support the implementation of base pay and only 43% do so for short-term incentives.

Compared with organizations using sophisticated software for administering base pay and short-term incentive programs, those still relying on spreadsheets are **more than twice as likely** to say that not having the right technology is a challenge to delivering effective pay for performance.

Thirty percent of organizations that identify technology as a challenge are planning to introduce new technology this year. However, about 20% of those who don't identify technology as a challenge are also planning to introduce new technology this year, suggesting that these organizations are investing in technology to stay current or ahead of the pack.

Breakthroughs that matter!

Prioritize the use of compensation software and decision support tools.

To support the compensation function in helping managers make better pay decisions, organizations must ensure they have access to the latest software with global job leveling, benchmarking, and robust reporting and analytics capabilities.

Willis Towers Watson offers the only HR Software products built on more than 100 years of experience solving the most complex HR issues for the world's largest companies. Together, Willis Towers Watson Compensation Software and Global Data Services can help you deliver the *right* compensation to the *right* employee segments in the *right* way.

Why are employers considering making changes to their pay programs?



68%

Manager feedback



66%

Cost



60%

A changing market



54%

Feedback from employees



51%

Change in business model/strategy



4 Prioritize fair pay.

The issue: Despite having formal processes in place to prevent bias or inconsistency in hiring and pay decisions, many employers fall short when it comes to fair pay.

Fair pay is an essential element of an effective compensation program and an integral part of the employee experience. In addition, there is a growing concern over internal pay equity due to a combination of increasing employee expectations and formal legislation.

Most organizations give themselves high marks when it comes to having formal processes in place to prevent bias or inconsistency in hiring and pay decisions (Figure 3).

But are these formal processes actually delivering fair pay? The data suggest that, in practice, there is still a way to go. When it comes to gender pay equality, for example, women are paid significantly less than men on average. In the U.S., women's median earnings were 82% of men's in 2016 according to the U.S. Bureau of Labor Statistics. Similarly, Eurostat reports that in 2016 women's gross hourly earnings were on average 16.2% below those of men in the European Union. Two key factors contribute to these gaps: 1) differences in representation in higher paying positions and 2) differences in pay between men and women in the same/similar positions.

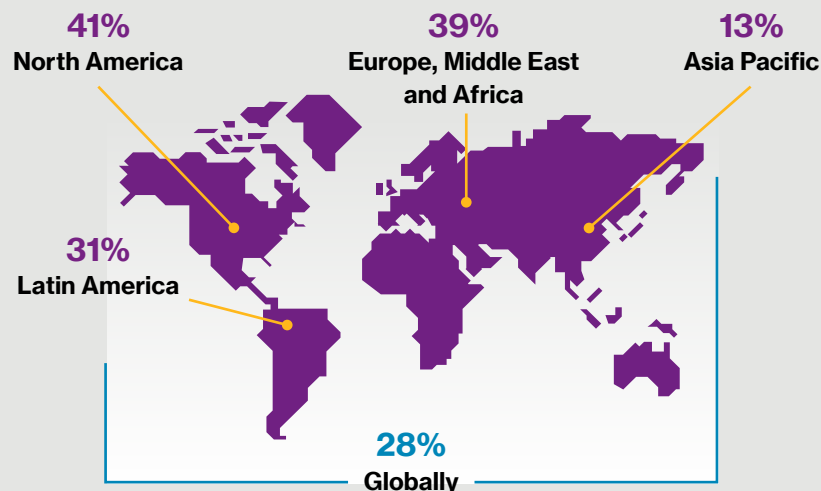
There are notable regional differences in the extent to which companies are using or planning to use annual pay increases to address gender pay equality issues over the next three years (Figure 4).

Figure 3. **My organization has a formal process in place to ensure there is no bias or inconsistency in:**



■ Strongly agree/Agree

Figure 4. **Gender pay equality will become a more important factor in base pay decisions in the next three years.**



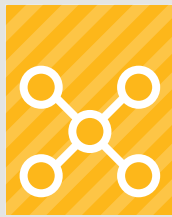
More broadly, when it comes to promoting diverse talent and an inclusive culture, globally over one in five (23%) organizations has formally structured and managed diversity and inclusion programs. These programs typically target gender (87%), people with disabilities (61%), racial and ethnic groups (53%), age groups (55%) and sexual orientation (41%).

Within these programs, organizations are more likely to have already emphasized:



40%

Flexible work arrangements



36%

Internal networks



33%

**Maternity support/
return to work programs**

Common target areas for this year and the next three years are:



48%

Reevaluating recruitment and promotion processes/succession plans



38%

Analyzing changes in pay differentials between job levels over time



35%

Increasing communication of policies and benefits promoting an inclusive culture

Notably, fewer are planning or considering initiatives that involve introducing recruitment and/or promotion targets (25%).

Breakthroughs that matter!

Conduct a diagnostic to formally assess the progress of the fair pay agenda in your organization and whether further actions are needed.

A more effective base pay program will also enable organizations to address pay equity issues that they may be facing. Conducting pay equity diagnostics can help employers understand the current landscape as it relates to fair pay and target actions to address any areas of concern.



5 Build a culture of pay transparency.

The issue: Many employers are unprepared to meet growing expectations of pay transparency.

A combination of generational preferences, legislation and publicly available comparative data is contributing to today's heightened expectations with regard to pay transparency. Yet, there's still a relatively low-level of pay transparency, which involves providing clarity around how pay decisions are made as opposed to disclosing employees' actual salaries.

The reasons for this lack of transparency vary. In some cases, an organization's compensation system may be so confusing that it's difficult to clearly explain the decision-making process. In other cases, the results may be embarrassing – for example, an organization may have a substantial gender pay gap.

While almost one-fifth of companies have already taken action to increase the level of transparency around pay decisions, another 20% are planning to take action this year and 28% are considering taking action over the next three years (Figure 5). The task of increasing transparency becomes more challenging with the growing complexity of pay decisions.

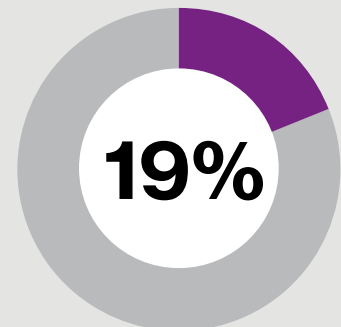
Breakthroughs that matter!

Establish a clear and future-focused reward strategy to help explain compensation decisions.

Before employers can be transparent about their pay decisions, they need to get their houses in order and be able to clearly explain the mix of factors influencing pay decisions as well as the reasoning behind the results – especially in countries where organizations must meet pay disclosure regulations. A transparent pay culture starts with the communication of a clear reward strategy and accompanying pay philosophy.

A reward and career framework can serve as the foundation for open conversations about pay decisions and facilitate communications about the skills and other factors required to be successful. It's also essential to equip managers with the necessary training and tools to explain the basis for pay decisions in the context of the broader reward mix.

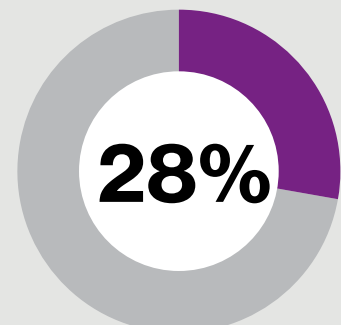
Figure 5. Companies are taking action to increase the level of transparency around pay decisions.



Already taken action



Planning to take action this year



Considering taking action over the next three years

Putting it all together

The following practices should underpin an organization's efforts to develop compensation programs that have clear objectives, and deliver value to employees and employers:



Refocus decision making from a look back at past performance to an increased emphasis on the knowledge and skills that support future business models as well as the perceived potential of the employee.



Target your spend by using segmentation to better understand the roles and functions that deliver the most value, and the factors that should drive the spending in those roles/functions.



Ensure your technology keeps up with changing program requirements and supports decision making.



Build manager capabilities. Managers must have the tools to make complex pay decisions and the ability to explain the decision-making process. In some cases managers may be a step ahead of HR when it comes to deciding how factors should be weighted in pay decisions.



Develop a robust communication program that promotes transparency and clarifies the role each component of an organization's compensation package plays in the overall talent value proposition.

Effective compensation programs are an important part of the talent value proposition and as such are linked to increased attraction and retention of top talent, improved employee engagement and higher levels of financial performance.

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About the survey

The Willis Towers Watson Getting Compensation Right Survey fielded in March and April 2018. It includes responses from nearly 2,000 participating organizations in 48 countries. The participants represent a wide range of industries and geographic regions.

