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SPECIAL REPORT: COMPENSATION

As competition for top talent heats up, employers are putting teeth into their pay-for-performance programs. Broad-based compensation plans that reward everyone during flush times no longer cut it. This special report on compensation describes how companies as varied as TIAA-CREF, Payless ShoeSource and TriQuint Semiconductor are making pay for performance work. Other stories examine CEO compensation and look at the changing nature of compensation surveys.

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Raising the Performance Bar

As competition for top talent heats up, employers are putting teeth into their pay-for-performance programs. Broad-based compensation plans that reward everyone during flush times no longer cut it.

By Jessica Marquez
Infographic by Thomas Kimball

New York nonprofit TIAA-CREF has always been known as a nice, conservative financial services company. But four years ago, the new CEO began realizing that nice guys often finish last.

Reeling from losing its contract to manage New York state's $1.8 billion college savings plan in 2003, Herb Allison set out to improve the company's performance. One of his ideas was to create a new compensation system that would reward top talent with bigger bonuses and identify and weed out underperforming employees.

Half a continent away in Topeka, Kansas, Payless ShoeSource was having similar troubles. After seeing its market share erode over several years, in 2003 it embarked on a business turnaround plan, under which the company devised a compensation system that would differentiate between its strong performers and other employees.

"We have always had a very caring organization, but when that goes too far it can breed mediocrity," says Betty Click, vice president of human resources operations and learning and development. "We wanted to create a culture where employees were individually accountable for their performance."

As the job markets pick up, more employers like TIAA-CREF and Payless are making employees accountable for their performance by matching their compensation to it. According to a June 2004 study by Synygy, World at Work and Sibson Consulting, 72 percent of companies say that paying rewards based on individual performance was the top goal of their organization's performance management program.

Skills shortages and rising benefits costs mean that companies can no longer afford to have broad-based compensation programs that merely reward employees when the company does well, says Laurie Sejen, a consultant with Watson Wyatt Worldwide. Fifty-eight percent of employers report at least moderate difficulty attracting critical-skill employees in 2005, compared with 40 percent in 2003.

CHANGES IN EMPLOYERS' REWARDS PERSPECTIVES IN THE PAST 10 YEARS

Since 1996, companies have made modest progress in linking their reward systems to their business strategies and encouraging desired employee behavior, according to Watson Wyatt.

Source: Watson Wyatt, "Strategic Rewards and Pay Practices: The Need for Execution," 2005/2006

Their efforts seem to be working. Seventy-nine percent of employees say their bonus awards vary based on their individual performance, according to Watson Wyatt. Fifty-five percent think that it has become harder to earn a bonus in the past three years.

CULTURE SHOCK

TIAA-CREF initially started raising the bar for employee performance in 2003 when it introduced a five-point rating system for its 6,000 employees. This marked a huge shift in culture for the firm, which had never paid bonuses and salary increases based on an individual's performance, says Shelly Carlin, vice president of HR for rewards and operations.

CHANGES IN EMPLOYERS' REWARDS PERSPECTIVES IN THE PAST 10 YEARS, PART II

Although companies have made modest progress, they still need to focus on making sure employees understand their reward plans, according to Watson Wyatt.

	1996	2005
Compensation strategy is clearly articulated *	30%	30%
Employees understand reward plans *	25%	23%
Effectiveness of reward plans is measured on an ongoing basis *	20%	21%
Employees are involved in design & modification of reward plans *	6%	2%
Merit increases are regarded as entitlement **	52%	49%

* Percentage reporting "to a great extent" or "to a very great extent"

** Percentage reporting "to a great extent"

Source: Watson Wyatt, "Strategic Rewards and Pay Practices: The Need for Execution," 2005/2006

Under the new program, an employee rated as a 5 receives a merit increase and bonus around the 75th percentile of the industry, while a manager would review employees with low scores to make sure they were in the appropriate jobs and getting the right training.

But in 2004, the first year the ratings system was in place, TIAA-CREF did not give managers guidance on how to apply the ratings. As a result, the company saw a high number of 4 and 5 ratings, but that didn't match up to the company's business performance. It was clear that managers were hesitant to give their employees a 3 because it connoted "average," Carlin says.

To correct the situation, last year TIAA-CREF told managers that only 32 percent of all employees could get 4s and 5s. Managers and employees complained, saying the new system was unfair. "Employees felt like they were working harder than ever and could not understand why they were not 5s," Carlin says.

TIAA-CREF realized it needed to get its managers to understand the thinking behind the ratings. In December and January, Carlin and her staff held 90-minute training sessions for managers to make sure they understood the business need for performance ratings and differentiation. They got tips on how to explain to upset employees why they were not 5s.

"We had to make sure they understood that we are raising the bar for the entire company," Carlin says. TIAA-CREF will review employee feedback and whether the company paid for performance and differentiated between high performers and other employees to gauge the success of the program. "But the real test is how people feel about it," she says.

ACCOUNTABILITY FOR ALL

At Payless, the company's 1,500 associates received bonuses based on the company's earnings. But in February 2005, the firm made 20 percent of employees' bonuses based on individual performance. Last spring, Payless began basing employees' merit increases on individual performance as well.

Like many companies, Payless had been hesitant to determine salary increases based on individual performance for fear of demoralizing employees, Click says. But now, more companies are doing this because it helps retain top performers and gives more teeth to the culture of accountability. The average salary increase for high performers jumped from 9.5 percent in 2004 to 9.9 percent in 2005, while the average merit increase only rose 0.2 percent over the same period.

Payless' new program requires its 12 business unit leaders to create a "nine box," which is just what it sounds like: a chart with nine boxes. Each box details an employee profile, how the manager should address the employee's performance and growth potential and what the range of the salary should be.

For example, one box may name a "derailed employee," who would not receive an increase in compensation and for whom the manager needs to establish an exit strategy. On the opposite side of the chart would be the star performer, whose compensation should come in above the 85th percentile of the market, and for whom the manager needs to create a promotion and retention strategy.

"The system not only creates accountability for the employee when they get their reviews, but it makes the managers accountable for developing and managing their talent," the company's Click says.

After soliciting feedback from their managers and plugging the names of their staff members into the boxes, executives review their charts with their HR managers and then with the CEO to make sure they are focusing on competencies and not on "why this employee is a great guy," Click says.

It's a lot of work. Click estimates that managers are now spending 50 percent more time on the review process.

This year, Payless managers will hold their first employee reviews under the new system. And then they will know if all the work is worth it.

To measure the program's success, Payless will review employee feedback, as well as retention of key talent and how well the company does at moving identified talent up through the organization, says Sally Burk, director of compensation.

But the real test for every company trying to create accountability through compensation is not in the design, but in execution, she says.

"Do we have the stomach to make the tough decisions to deliver the differentiation we are looking for?" Burk asks. "Those are the questions we all need to make sure we know the answers to." wfm

Performance culture starts in the boss' office

In adopting pay for performance, firms that fail to first hold the CEO accountable risk losing credibility with their employees

As companies get serious about tying employee pay with performance, many are starting at the top.

Last year, 30 out of 100 major U.S. companies based a portion of stock granted to CEOs on performance targets, up from 23 in 2004 and 17 in 2003, Mercer Human Resource Consulting reports. Companies that are trying to create a pay-for-performance culture have to begin with their chief executive officers or they'll face the wrath of the rank and file, says Diane Gerard, a vice president at Aon Consulting.

"If employees feel they are being treated differently than their CEOs, they are going to complain bloody murder," she says.

This is a big issue for employers that have terminated their companywide stock incentive plans, because those employees often resent the CEO who continues to get options when they do not, says Ira Kay, global director of executive compensation consulting at Watson Wyatt Worldwide.

These employees will pay more attention to how CEOs are paid next year, when the Securities and Exchange Commission rule requiring companies to disclose what metrics they use to align executive pay with performance takes effect, says Mark Reilly, a partner at 3C-Compensation Consulting Consortium in Chicago.

In the past, companies have just handed executives stock option grants. But the recent accounting rule change that requires companies to expense those options in their financial statements has prompted many companies to move away from these compensation tools. That trend, along with increasing shareholder criticism that options do not truly align executive pay with performance, means that companies are setting more specific performance metrics, says Doug Friske, managing principal at Towers Perrin.

In many cases, companies are replacing stock options grants with performance-based restricted stock. By doing this, companies provide a timeline with their performance targets. If the company reaches its targets early, the CEO receives shares early, but they may vest at a later date.

For example, the company could advise the CEO that if the firm reaches a certain performance target within the next 12 months and the CEO stays for two more years, the executive will receive 1,000 shares of stock. But if the company does not meet its goal, the CEO will only receive 500 shares of stock. "More than half of large companies are doing this today, up from one-third two years ago," Kay says.

Some companies are taking a more aggressive stance and adding forfeiture clauses to their performance targets. Under this arrangement, the CEO would not receive equity grants unless the company meets certain performance goals. Thirty-three percent of large U.S. companies are using this approach, says Jamie McGough, a principal at Hewitt Associates. This is going to be the more prevalent practice for companies from now on, he says.

The challenge for employers is maintaining a balance between setting the CEO's pay for performance and making sure that the goals to which pay is tied are reasonable, Kay says. With CEO turnover rising, turnover is an issue that every company has to take seriously.

"If you make the carrot too hard to bite, there could be unintended consequences," he says.

—*J.M.*

CEO COMPENSATION TRENDS

CEO compensation changes in 2005 were modest, according to Mercer Human Resource Consulting. Pay and corporate performance were "closely aligned."

PERCENTAGE CHANGE FROM PREVIOUS YEAR

Year	CEO annual compensation (salary and bonus)	Exempt employee annual compensation	Corporate profits	Annual CPI
1996	5.2%	4.0%	11.0%	3.0%
1997	11.7	4.2	8.9	2.3
1998	5.2	4.2	5.0	1.6
1999	11.0	4.2	15.1	2.2
2000	10.0	4.2	8.9	3.4
2001	-2.8	4.4	-17.8	2.8
2002	10.0	3.8	14.8	1.6
2003	7.2	3.6	19.2	2.3
2004	14.5	3.4	23.0	2.7
2005	7.1	3.6	13.0	2.4

Source: Mercer Human Resource Consulting

Web access transforms compensation surveys

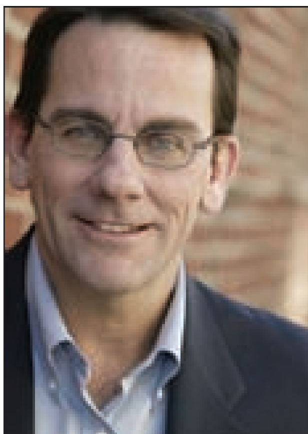
Giving users the capability to do highly detailed searches has fueled demand for more refined salary information

TECHNOLOGY HAS dramatically changed salary surveys, giving companies—and employees—unprecedented access to information on the market value of almost any job imaginable.

At first, that sounds great: Salary information is infinitely more useable now that it's on the Web, as opposed to being trapped in the pages of a report. Users can specify their parameters—employee education and training, company size, industry or location—to arrive at very specialized salary profiles.

If a client wants to know the salary range for software engineers in Seattle with five to nine years of experience who program in C++ for e-commerce companies, that can be delivered with ease, says Fred Whittlesey, chief compensation officer for Payscale. The online compensation-information company is based in Seattle and began business in 2002. The company won't disclose the size of its database. It serves small and midsize employers, as well as individuals looking for jobs—or a raise.

"We are trying to say that business-people can't live with wide variation and stale data," he says. "... We think by providing more immediate data and more refined data, you make better business decisions."



"We are trying to say that business-people can't live with wide variation and stale data. ...We think by providing **more immediate data and more refined data**, *you make better business decisions."*

—Fred Whittlesey, Payscale

The ability to reshuffle information has created its own set of problems, however. Companies used to be content with compensation information on broad benchmark jobs, says Bill Coleman, senior vice president of compensation for Salary.com, which also serves both employers and individuals. Its database includes information on 1.3 million current job holders and 5,000 companies. Satisfaction with more general benchmark salary data went out the window once employers got access to actual databases and were able to set up their own search parameters, he says.

"The easier it is to get data, the more you want," he says. "The demand is increasing because the flow is easier. Bosses and CFOs and CEOs and managers are expecting to find more data." That puts additional pressure on comp professionals to keep fine-tuning results. Sometimes, they get just as caught up in the data chase, he says. "It's like crack for comp people."

It can be just as addictive for employees and job seekers. They can go to the Web to see what a job is "worth." They're not shy about confronting their current or would-be employers with that information.

"Employees are aware of the compensation tools they can use," Whittlesey says. "They prepare themselves for meetings, or hiring, or performance reviews. That's challenging HR to change and become more open."

Some Web-based salary information that employees present to make their case for a raise can be too broad to be useful, says Steve Brink, global leader for human capital products solutions at Mercer Human Resource Consulting. Mercer has been in the compensation survey business for 40 years and has 15,000 company entries in its global database. In the U.S. alone, the surveys cover more than 15 million employees.

Employers need to be sure they are armed not just with a job title and the salary for it, but with the right set of comparisons to counter an employee's argument, he says. Job content, not just title, also is critical

Brink also disputes the notion that too much compensation information is overloading employers, at least among Mercer clients. Most organizations that have a solid compensation department know what they want beforehand, he says.

"They have an idea of peer group they want, and where they want to be matched to positions. How do you want to pay? Is it the 75th percentile of this industry, this peer group? They can do that analysis. They can slice and dice to get to right answer."

Technology notwithstanding, market data is only one way of gauging what a job is worth, the experts say.

"Companies used to rely heavily on internal equity and salary structure," Coleman says. "But in this addiction model, the more you think you can get, the more you want. HR and comp are more driven by external market data than internal structures."

Brink thinks that picture is changing. Before 1970, compensation was set largely by the measure of a job's worth inside the organization, he says. As the year 2000 approached, a rapidly expanding economy and a highly competitive job market meant there was "a push to get much more market-focused."

Now, he says, companies are again weighing their own salary imperatives with what the market indicates a job might be worth. "It's going back to the center," Brink says.

—Staff report

Communicating beyond ratings can be difficult

Resentment over being deemed 'average' prevents some employees from taking in the full content of performance reviews

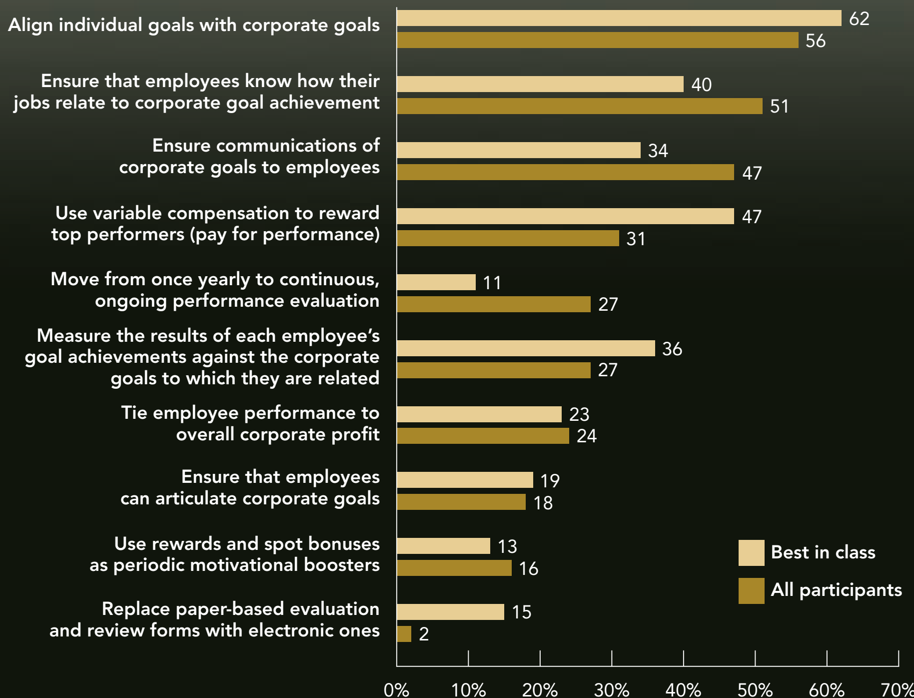
When TriQuint Semiconductor implemented a more formal pay-for-performance system for its 1,600 employees, people were outraged.

"Managers were furious. Employees were furious," says Deborah Marsh, director, worldwide human resources. "We had one person quit because he said he had never been called average before."

As companies like TriQuint implement more rigid performance-based compensation programs, many are being confronted with pushback from both managers and employees. The introduction of formal ratings to determine compensation is particularly hard for employees who have been meeting expectations but are rated as 3s, which implies mediocrity, says Ravin Jesuthasan, managing principal at Towers Perrin.

"Companies need to spend a lot of time communicating to employees that the definition of success has changed and this is what it means for you," he says.

Some employers are addressing this by divorcing the discussion about performance from the discussion about pay, says Steve Gross, a compensation consultant with Mercer Human Resource Consulting. "Otherwise, employees are just keeping a scorecard in their head while the manager is trying to talk about their goals," he says.



TriQuint, which is based in Hillsboro, Oregon, had a five-point employee rating system in place for years, but it was only when the company's new CEO, Ralph Quinsey, joined the firm in 2002 that the company started applying it in earnest, Marsh says.

Under the program, 20 percent of employees could receive 4s and 5s, 50 percent could receive 3s, and the rest were 1s and 2s.

For employees, the change was significant because these ratings, along with how their managers ranked them within the organization, determine how they get paid.

Managers reviewed these ratings when deciding merit increases, stock option allocations and promotions, Marsh says.

"People were up in arms and many weren't reading their reviews," Marsh says of employee reaction.

The issue was that employees were getting so wrapped up in their ratings that they weren't paying attention to the content of the review, she says. "The ratings became demoralizing instead of motivating."

In June 2005, TriQuint took the ratings out of the conversation.

"Now the conversations are around goal setting and competencies rather than ratings," Marsh says.

Rather than hear about their ratings, employees talk to their managers about how their contributions are aligned with their business division's goals. The compensation part of the conversation is held months later.

Managers still use employee rankings to determine their compensation, but those rankings are not shared with employees, Marsh says.

How well this approach works remains to be seen. Employees are going through the revised compensaton process now.

To determine the program's success, the company will review turnover among highly ranked employees and check on how well each department did in meeting its goals.

"The new process may not be as cut and dried as before, but so far managers seem to like it," Marsh says.

—J.M.

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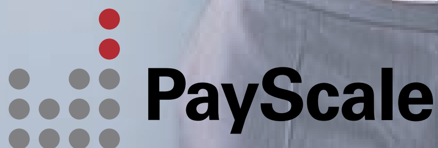

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