

# Did the Recession Really Affect Incentive Program Changes Around the World?

Incentive plans are changing; some because of the recession and some despite it.

By Kevin Abbott, Performance and Reward Centre (PARC); Ryan Johnson, WorldatWork; and Nigel Turner and Amanda King, PARC

During the past three years, the role of incentives around the world has had greater public prominence than ever before. This phenomenon likely was inevitable given the perceived relationships between incentive practice in the banking sector, the financial crisis and the regulatory actions that followed.

In the United Kingdom, the United States and no doubt elsewhere, variable pay outcomes have become significant news events. The terms “bonus” and “incentive” have become tarnished. The traditional aims of incentives — to provide motivation, focus and



# Nearly one-third of the companies interviewed had made changes strictly driven by the recession, while half had made changes for other reasons. Altogether, more than three-quarters of companies had made significant alterations to their plans.

variable cost — often seem to have been undermined. The public views executive incentive plans as being “bonuses” despite the fact that such plans are an ingrained part of the rewards program for employees at all levels.

At the same time, the economic environment has, of course, been difficult. Demand for many products and services has plunged. And while companies have been forced to lay off employees, thereby doing more with less, they have needed to keep their remaining employees engaged and focused.

Developing and operating incentive plans in such circumstances has not been easy. Decisions that take account of several perspectives need to be made to ensure that incentives continue

to operate in an appropriate way. Recently, interviews were conducted by WorldatWork and Performance and Reward Centre (PARC) in London of 20 companies associated with either PARC or WorldatWork. The companies interviewed are all commercially focused, and most are publicly held. Sixteen were headquartered in the UK, five in the United States and two in Germany at the time of the interviews (May-July 2010).

The interviews found that, partly because of the recession and partly despite the recession, there has been considerable change to incentives during the past two to three years. As shown in Figure 1, nearly one-third of the companies interviewed had made changes strictly driven by the recession, while half had made changes for other reasons. Altogether, more than three-quarters of companies had made significant alterations to their plans. Around two-thirds of companies changed their short-term incentives (STIs) and approximately one-third changed their long-term incentives (LTIs), with most changing both. Let’s take a closer look at what prompted these changes.

## The Recession

In most cases, changes to incentive programs followed major declines in markets with severe impact on profitability. As a result, prior incentive

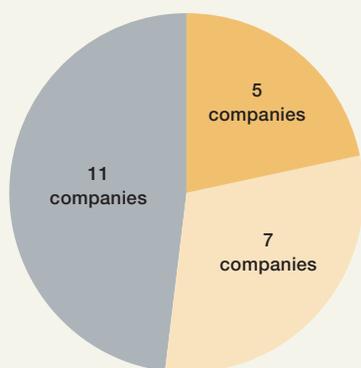
structures or measures were no longer considered appropriate for the new and volatile circumstances. Some of the actions involved discretionary “workarounds” to produce an incentive outcome that took better account of the context and circumstances of the performance. Others involved changes to measures or additions to measures going forward so that the plan (usually the STI) continued to be relevant and challenging but fair. In one company, the financial crisis led to a thorough restructuring of incentives and, particularly, to governance processes.

To some extent it is surprising that more organizations did not need to adjust their incentives because of the volatility. However, the interviews found that a significant proportion of companies continued to increase profits during the period. In some cases, this may be because their markets did not suffer during that time; in others, it may be due to the company’s actions to protect or increase profitability.

The interviews also found that certain existing practices strengthened a plan’s ability to cope with the volatility that was experienced. These features provided flexibility through the following:

- Application of informed judgement to the determination of the performance outcome versus target by considering both actual results and results adjusted for major changes outside the unit’s control

FIGURE 1: CHANGES TO INCENTIVES 2008-2010



■ No significant change  
■ Change due to recession  
■ Change for other reasons

- A high level of discretion in shaping incentive funding and outcomes via a pool and a nonformulaic distribution system.

Aside from impacting incentive outcomes directly, the need to manage costs (and optics) during a recession may mean that improvements to incentive plans, such as an extension of the plan to additional staff or a more generous level of target bonus, can no longer be implemented and must be deferred. This was the case for two of the interviewed companies.

### Changes in the Market or Structure of the Company

Eleven of the interviewed companies made changes for reasons other than the recession. These changes include:

- Improving risk management of reward in financial services companies. Only one company outside financial services mentioned conducting a risk audit on its compensation systems. A recent Hay Group interview also found only a small proportion of UK companies cited risk as a driver of change in their variable pay programs.
- Improving plan measures by adding new measures to provide additional focus on key issues, such as the generation of cash, and/or lessening reliance on certain measures that were no longer key goals in business strategy.
- A rebalancing of the organizational levels, including individual performance, at which performance is measured to reflect the changing nature of the business and workforce.
- Simplifying and standardizing plan structures and measures following a merger.

### Nonfundamental Changes

Some of the companies made significant changes just prior to the recession. For example, one company had implemented a new variable pay

plan simplifying and standardizing practice across the globe, while another had extended its annual variable pay plan further down the organization. Others found that the recession confirmed that their existing model seemed to be working well and that further change was unnecessary.

The interviews also found that some of the companies' incentive plan practices provided enough flexibility to enable their plans to accommodate recession-related and nonrecession-related volatility.

### Design Trends

The interviewers anticipated finding a major increase in the use of "discretion," defined in this research as *the use of informed judgement in after-the-event assessment*. However, only a small number of companies saw an increased role for discretion, whereas, for example, informed judgement was felt to lead to more balanced outcomes for business performance, or more effective allocation of LTI grants, or was simply a necessary ingredient of assessing individual performance. However, most companies reported no change in the use of discretion, including those for whom it is a significant feature already, such as banks.

When asked where they felt their STI plans would sit on a continuum between preperformance incentives and postperformance rewards, most felt that their arrangements were closer to the "incentive" end of the continuum. Interestingly however, because of their use of discretion, a few of the banks felt their bonuses were closer to post-performance rewards. This difference with other sectors may reflect the profit-sharing nature of bonuses in investment banking and perhaps the importance of competitive pay in an employment market not exemplified by strong organizational loyalty.

Other factors may also come into play. Certain respondents commented that some geographic cultures seem more comfortable with the use of judgment than others, who prefer a more formulaic approach. There may also be an issue of trust here. Organizations that have a high level of trust in their management may feel more comfortable with judgment, especially where there is a track record to take that into account.

Although, because of volatility, one organization moved to a relative measure for its LTIs and another introduced relative performance as one of the lenses informing the outcome of its medium-term bonus, the interview results showed no major trend toward stronger use of relative performance.

The most noticeable trend, exhibited in more than one-third of respondents, was toward an increased number of measures. Although the stated reason is based on the appropriateness of the new measures, a higher number of measures reduces potential volatility in the overall outcome. An increased range of measures seems consistent with the trends identified by UK consultancies.

The trend in 2009 for the STIs of UK executive directors was toward an increased focus on cash flow, cost and debt management. In 2010 the most common change was an increased focus on nonfinancial measures, according to consulting firm Deloitte. Also, as PricewaterhouseCoopers in the UK pointed out, there is greater use of corporate scorecards and specific projects, ethics and talent among the nonfinancial measures.

However, the trend to a higher number of measures may lead to greater complexity, which can reduce understanding and therefore effectiveness. At least five organizations mentioned that they had either completed a standardization/simplification process or were feeling an

## Where companies took action to change their plans because of the recession, they may have been addressing engagement by avoiding disengagement/demotivation.

increasing need to consider one. So the trade-off between comprehensiveness/reduced volatility and increased complexity may become a potential problem that needs addressing at some stage.

An interesting point of context for these recent changes is that, for at least a year, a majority of respondents had frozen the base salaries of their executives and awarded relatively constrained increases for other staff. In these circumstances, the STI was the major “movable part,” so getting it right may have been considered even more important than at other, more normal, times.

In terms of variable pay outcomes for 2009, although some were clearly below target, a majority of the respondents who were asked about this reported that their STI payouts were at or above target. This positive outcome reflected various factors for different companies. These included consistent strong performance, significantly improved performance versus the prior year, and adoption of targets for 2009 that took the poor business context into account. Survey data from UK consultancies supports the finding that payouts for 2009 were generally higher than those for 2008.

### Conclusion

Where companies took action to change their plans because of the recession, they may have been addressing engagement by avoiding disengagement/demotivation. Plans that fail to recognize high performance in some areas of the organization, targets that are viewed as unachievable, or measures that have little line of sight

do not enable an incentive plan to provide focus on and reinforcement of what is important in the current year. Nor do they support trust in management. Skeptics might counter that changing the measures is simply a continuation of the trend of regularly adjusting performance measures when they do not pay out as expected. However, priorities do change, and keeping incentives relevant makes practical business sense.

As one seasoned UK rewards practitioner commented to the interviewers: “Rewards may not ‘motivate’ performance, but it can ‘drive’ performance. You reinforce what you want to do by putting the rewards plan behind it. However, new things can become a given after a couple of years, and you need to move on. Incentive plans are a great opportunity to communicate what you want to achieve, providing they are fit for purpose in doing that. Sadly, not all of them are.” 

---

#### EDITOR'S NOTE

The complete report can be found at [www.worldatwork.org](http://www.worldatwork.org).

---

#### ABOUT THE AUTHORS

Kevin Abbott is a partner with the Performance and Reward Centre in London, pension trustee director and rewards consultant. He can be contacted at [abbott\\_kevin@yahoo.co.uk](mailto:abbott_kevin@yahoo.co.uk).

Ryan Johnson is the vice president of publishing and community for WorldatWork in Scottsdale, Ariz. He can be reached at [ryan.johnson@worldatwork.org](mailto:ryan.johnson@worldatwork.org).

Nigel Turner is an independent rewards consultant and writer and researcher for the Performance and Reward Centre in London. He can be reached at [nigel@parcentre.co.uk](mailto:nigel@parcentre.co.uk).

Amanda King is an independent HR consultant working with the Performance and Reward Centre in London as a researcher and writer. She can be reached at [amanda@parcentre.co.uk](mailto:amanda@parcentre.co.uk).

### RESOURCES PLUS

For more information, books and education related to this topic, log on to [www.worldatwork.org](http://www.worldatwork.org) and use any or all of these keywords:

- Incentives + recession
- Incentive programs
- Short-term incentives
- Long-term incentives
- Bonus pay.