

Balancing Cost and Talent Needs

Tough Solutions for Tough Times

Originally published by Towers Perrin

The deepening recession is placing new burdens on workforce management strategies and raising difficult, and increasingly urgent, questions about how to make the best use of scarcer dollars for ongoing reward and benefit programs.

On the one hand, companies know that they need talent — skilled people who remain committed to long-term growth and who want and expect competitive and fair pay. On the other hand, compensation and other HR budgets are under pressure, in the face of deteriorating balance sheets, reduced earnings, tight credit, falling customer demand and other business challenges. People costs remain one of the largest expenditures for many organizations and an obvious area of scrutiny today.

Evidence of deteriorating workforce conditions is everywhere:

- *More and more companies are announcing hiring freezes or layoffs.* Data from a survey of over 400 U.S. employers in January of this year show that 60% have completed, or are in the process of planning, a hiring freeze, while another 40% have completed or are planning a “targeted” staff reduction (defined as less than 10% of the workforce). And another fifth have already laid off, or will soon lay off, a more significant number of workers. The Labor Department reported that the U.S. lost nearly 600,000 jobs in January, bringing the total decline in payroll employment to 3.6 million since December 2007. And almost half of that decline occurred since December 2008.
- *Larger numbers of workers are postponing retirement,* exacerbated in many cases by declining 401(k) balances, but also by general concerns about the financial wisdom of leaving the workforce right now. In another recent Towers Watson survey of U.S. workers, conducted in December of 2008, the percentage planning to retire was 9%, down from 14% reported by the same group of respondents in a prior survey just four months earlier. And fully 65% of the December respondents said the risk that they won't be able to afford to retire when they wanted to had increased somewhat or significantly.

- *Workers who can are hanging onto jobs.* Forty-five percent of the respondents to our December employee survey had no plans to leave their current jobs, up from 37% in a mid-2007 survey. While a slowdown in turnover is a blessing in some cases, other related issues crop up. Are the workers who want to stay those the company needs to keep right now? If not, what actions are required for those employees who may not be performing at desired levels?
- *With unemployment rising, companies can expect to see higher health care costs.* Historically, costs rise for active employees due to postponed retirements. Moreover, company group health plans take on more dependents of retained employees with spouses who have been laid off.
- *Finally, even as companies take significant steps to lower their workforce costs through staffing cuts and other measures, talent shortages remain.* This creates a corresponding need for sophisticated reward programs to retain and engage employees with critical skills at all levels.

Companies also face continuing challenges from the havoc wreaked by the capital markets on retirement programs. Besides the significant slide in 401(k) plan asset values, the drop in stock prices has brought large reductions in pension plan funding levels. Towers Watson's benchmark plan funding ratio slumped to 64.1% at the end of January 2009, the lowest on record. The low funding levels are putting companies under pressure to step up contributions at a time when cash flows have slowed down markedly.

Amid the gloom, companies await signs that the stimulus package and other government actions will start to take root, helping to shore up the economy, boost spending and ease access to investment capital. But even as they continue to focus on cost reduction in one form or another, a significant number are also dealing with a challenge that was largely nonexistent during prior recessions — keeping and, in some cases, finding talent.

Although the notion of talent retention or shortages may seem at odds with current reality (and the rising unemployment rate), the issue persists not only in key industries like health care and information technology, but also in critical skill areas. And while the situation may ease temporarily in some areas, demographic trends suggest far fewer job entrants will be coming into the workforce over the next few decades than the number of people who exit.

For these and other reasons, most organizations remain acutely aware of the fact that they can't afford to compromise their talent agenda, especially given the importance of that agenda to their long-term growth and ability to execute their strategy. And they know this means keeping employees engaged at a time when engagement levels could slip as anxiety and distraction levels rise.

So the ultimate question is: How can companies effectively meet what appear to be competing goals — to reduce spending, especially on people programs, while retaining and engaging the key talent needed to make it through the downturn and pave the way for a return to growth? The answer lies in **optimization** — of both the workforce and corresponding reward programs.

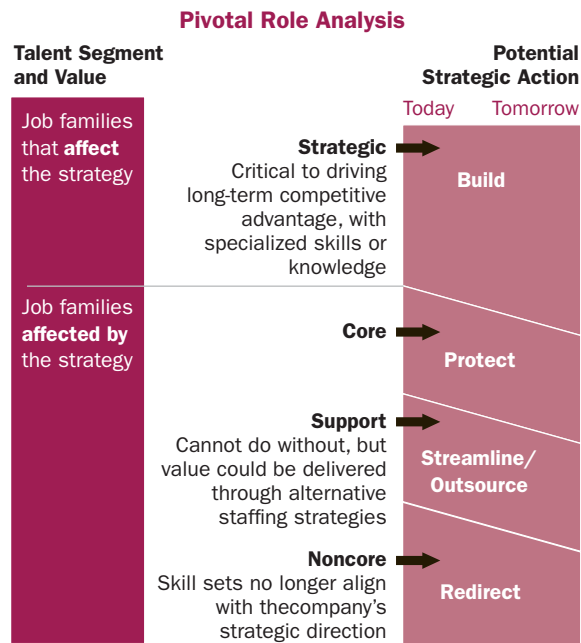
Put simply, optimization means ensuring that whatever funds are available are spent for maximum value to the organization. That, in turn, requires a company to do three things:

- Identify the people who make critical contributions to the organization and perform at consistently high levels — as well as the people whose skills are less critical and those whose performance lags.
- Allocate rewards in proportion to people's actual value and performance.
- View rewards from a comprehensive perspective, focusing not just on monetary elements like salary and bonus, but also on so-called "relational" rewards — career development, stretch assignments and other programs — that often require less investment but actually have a greater impact on employee retention and engagement.

Pivotal Role Analysis: Identifying How People Contribute

These days, most large organizations have sophisticated processes and tools to identify high performers or high-potential employees when making critical decisions about reward programs. But performance is only one piece of a larger workforce assessment. It's also important to focus on the roles people are in and the impact of those roles relative to the company's strategy and business model.

Exhibit 01. Pivotal Role Analysis Can Strengthen Talent Management Decisions



Source: The Conference Board, *Strategic Workforce Planning*, 2006

While successful organizations count on their entire workforce to contribute to results, there's no question that each person's level of contribution and impact on results differs according to his or her role, expertise, experience and other factors.

An approach called pivotal role analysis can help a company accurately evaluate which job families and roles have the most impact on business strategy and growth. Basically, it involves grouping the workforce into four broad categories (*Exhibit 1*), based on the impact people's jobs have on the strategy of the organization and what drives value for it. These categories are:

- **Strategic:** The role directly impacts the company's ability to achieve its strategy.
- **Core:** The role (typically, operational) is primarily focused on executing the strategy.
- **Support:** The role (typically, staff positions) is necessary, but may be able to be provided through less expensive, alternative staffing arrangements (e.g., outsourcing).
- **Noncore:** The role and skills no longer align with the company's strategic direction.

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Consider, for example, an airline whose strategy is to deliver a superior passenger experience to its most frequent and high-margin fliers (primarily business travelers) to gain their loyalty and travel dollars. In this case, the airline’s strategic employees include those who directly interact with the target customers, including first- and business-class flight attendants, and select call-center representatives. The mechanics hold core jobs — necessary to fulfill the basic service, but with little or no impact on the business traveler’s experience. As for catering staff, that might be deemed a support role and provided through a third-party vendor.

The value of this analysis, as Exhibit 1 shows, is to guide strategic decisions around recruiting, development, retention or restructuring. People in strategic roles or job families with specialized skills or knowledge represent a talent base that demands special attention when allocating reward dollars — in good times and bad. Ideally, a company would want this group of people to grow over time. People in core jobs, by contrast, do need to be retained, but may not require as great an investment of either time or money. Of course, these categories can overlap to a fair degree, and represent loose groupings at best, so reward strategies are not mutually exclusive across the groups.

Optimizing Rewards: A Big Agenda

Once an organization has classified its workforce, it can then begin the work of rewards optimization. The goals here are threefold:

- Reduce absolute levels of cost.
- Shift the mix of cost from fixed to variable to the degree feasible and desirable.
- Allocate rewards to ensure that a disproportionate share of the rewards pool actually goes to high performers and pivotal talent.

How is all this accomplished? The matrix in *Exhibit 2* illustrates one way that a company can allocate a portfolio of rewards — both monetary and relational — by taking into account both role importance and individual performance. This approach allows dramatic differences in both the scope and level of rewards. A top performer in a key role or job family could expect to earn two to three times as much in total compensation as an individual just meeting expectations, for instance, and would likely be guaranteed one or more special assignments as part of a career development path. By contrast, a lower performer, even in a critical role, would receive a significantly smaller compensation package and, potentially, no bonus at all.

“Rewards differentiation is not only a cost management tool, but also a way to retain and engage high performers and pivotal talent in any business environment.”

Exhibit 02. Both Roles and Performance Are Important in Optimizing Investments in Talent

		Individual Performance				
		Low				High
Importance of Role	High	Below Threshold	Threshold	Target	Maximum	Above Maximum
		<ul style="list-style-type: none"> • Below-average merit • No incentive • Eligible for equity • Normal training 		<ul style="list-style-type: none"> • ~1x to ~1.5x average merit • Target incentive • ~1x to ~1.5x target equity • High-performer training • Consideration for developmental assignments 		<ul style="list-style-type: none"> • ~2x average merit • ~3x target incentive • ~3x target equity • High-performer training • Targeted for developmental assignments
		<ul style="list-style-type: none"> • No merit • No incentive • No equity • Normal training 		<ul style="list-style-type: none"> • Average merit • Target incentive • Target equity • Normal training 		<ul style="list-style-type: none"> • ~1.5x average merit • ~2.5x target incentive • ~3x target equity • Normal training • High consideration for developmental assignments
	Low	<ul style="list-style-type: none"> • No merit • No incentive • No equity • No training • Immediate performance plan 		<ul style="list-style-type: none"> • Below-average merit • Target incentive • Below-target equity • Normal training • Eligible for developmental assignments 		<ul style="list-style-type: none"> • ~1x to ~1.5x average merit • ~2x target incentive • ~2x target equity • Normal training • Eligible for developmental assignments

In essence, rewards optimization means companies have to pick their spots in terms of those segments of the population that really do require high levels of investment, while scaling back from other segments of the population. This is arguably the toughest challenge of rewards optimization in today's harsh economy since traditionally, companies, and especially individual managers, have found it difficult to make these kinds of distinctions. As compensation professionals know all too well, the temptation to "peanut butter" the workforce — to spread rewards evenly without regard to job importance or performance — remains strong.

From a talent retention standpoint, though, rewards differentiation makes a huge difference. It's not only a cost management tool but, more importantly, a way to retain and engage high performers and pivotal talent in any business environment — directing resources to where they're most effective and valuable. And from a business standpoint, optimization helps achieve two other key objectives: improving corporate cash flow and cost structure through reward redesign, and reducing or better managing reward investments with less adverse impact on people or workforce programs.

Shifting Benefit Cost and Risk: Getting the Balance Right

Rewards optimization is not, of course, limited to pay. Benefits come into play as well and, in some respects, involve more complex decisions. For one thing, benefits continue to represent a very significant cost for most organizations. For another, they are an increasingly important element of security for employees, especially today. In our December 2008 employee survey in the U.S., adequate benefits rose to second place on employees' list of what matters most to them about their jobs, just behind having a secure job. Only months earlier, the ability to balance work and personal life had supplanted both of these workplace elements.

The key issue for employers, therefore, in optimizing benefits spend is to determine the right balance of cost and risk sharing with employees. And getting that balance right requires a detailed understanding of the role benefits play in the work experience, as well as employees' readiness (both their willingness and capability) to assume more responsibility for managing their health care and for accumulating sufficient savings for their retirement.

Through a research approach called Total Rewards Optimization (TRO), companies can test employees' receptivity to different combinations of benefits and examine the trade-offs employees are willing to make among differing portfolios of benefits based on a combination of perceived value and relative cost. People early in their careers, for instance, might give up a modest salary increase for increased career development or training opportunities. Mid-career employees might value a flexible work schedule over access to employee-paid retiree medical coverage.

TRO also examines how these trade-offs impact various behavioral outcomes, like employee engagement levels or retention, pinpointing where and when an enhancement in one benefit or reduction in another would begin to materially affect performance or engagement. It's not hard to see the enormous value these insights can provide in ensuring that company investments are sized appropriately and made where they'll matter most — and where they'll also drive desired employee behaviors and actions.

We have, of course, been witnessing a benefits evolution over the past decade, with a steady movement from plans providing a defined benefit amount or coverage level to so-called "account-based approaches" that give employees a defined amount of money to use for retirement savings or health care expenses. *Exhibit 3*, page 5, illustrates this evolution in the form of a continuum from modest to radical change. While companies that have shifted completely to the account-based model at the right arguably have more predictable costs, many are still likely to need additional savings in the current economy. For organizations that have yet to shift toward the right end of the continuum, now is the time to consider how far and how fast to make a transition.

Weighing the Impact on Long-Term Growth and Engagement

Whatever changes you may be contemplating in your workforce or reward programs, it's important to consider the potential impact on the organization's workforce and long-term growth. The actual return on cost takeout actions can vary dramatically over time, and hit one or more tipping points in diminishing returns. Take out too little cost and the organization may not rebound. Take out too much and organizational "anorexia" may ensue, severely risking not only future growth but survival.

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Exhibit 03. Changes in Benefit Programs Can Vary Significantly in Scope

Reward Programs	← Limited Action		Significant Change →
	Retirement Plans	<ul style="list-style-type: none"> Continue 401(k) employer contributions Minimize DB funding volatility 	<ul style="list-style-type: none"> Reduce 401(k) match Close DB plan to new entrants
Health Plans Actives	<ul style="list-style-type: none"> Reduce employer medical subsidy Modify medical design Consolidate and renegotiate vendor partnerships 	<ul style="list-style-type: none"> Implement account-based health plan (ABHP) option Consolidate all medical coverages with one vendor Implement workforce health strategy 	<ul style="list-style-type: none"> Implement ABHP total replacement program Eliminate employer dental subsidy Implement access-only retiree medical
Health Plans Retirees	<ul style="list-style-type: none"> Reduce employer subsidy for retirees 	<ul style="list-style-type: none"> Defined dollar cap or premium reimbursement provided Implement Medicare Advantage plans 	<ul style="list-style-type: none"> Eliminate some or all coverage for retirees — specifically Medicare-eligible

And the risks are real, especially given the importance of people’s skills and talents in an increasingly knowledge-based economy. Cut into staffing levels too deeply and you can lose the very talent — whether in specific skills or sheer numbers — required for growth. Another risk is a reduction in employee engagement and productivity, with people doing just the minimum to get by. Towers Watson’s normative database of employee attitudes shows dramatic differences in behaviors and views among employees at high-performing companies (those that are surpassing industry averages on key financial metrics) and employees at so-called “transitional” companies (those going through a traumatic organizational change).

Exhibit 4 shows these differences in terms of deviation from a global average for all employees in the database (more than three million worldwide). A critical point here is that employees at the high-performing companies have dramatically more positive views on virtually all aspects of the work environment and experience than their counterparts at transitional companies. And their engagement levels are higher as well.

These findings underscore how changes in the workplace and rewards can affect employee attitudes and engagement. This doesn’t mean an organization has to make large investments in rewards, but it does show that elements of the culture — leadership behavior, communication, company image and a host of other factors — make a big

difference in employees’ behavior and productivity. In practical terms, for instance, if leadership is accessible, visible and communicating effectively, an organization has a far better chance of minimizing negative reactions to reward changes and avoiding disruptions in performance or other potentially adverse consequences.

“There is a ‘virtuous circle’ between high performance — both individual and company — and getting the broad employment relationship ‘right.’”

Exhibit 04. High-Performing Companies Have Better Workforce Metrics Than Companies in Transition

Variations From Average: Globally



All of this underscores what we see as the “virtuous circle” between high performance — both individual and company — and getting the broad employment relationship “right.” Of course, these elements of culture also come under stress in difficult times, as organizations and their leaders tend to draw inward to work through the crisis. So it’s actually more important now than ever for companies to emphasize communication and leadership visibility to ensure that employees are seeing and hearing the messages that buoy their confidence, commitment and, ultimately, their level of engagement.

Companies understand in principle that changes in reward programs deserve thoughtful consideration because of the risks to long-term performance. There is less recognition, though, that the value employees place on various rewards differs markedly from group to group and individual to individual. Identical reward programs can yield widely different levels of value and satisfaction to employees, depending on their age, rank, seniority, job function or location.

Leading companies try to achieve the most efficient mix of reward programs — maximizing cost reduction without a negative impact on employee behavior — by taking into account how rewards affect employee behavior and attitudes. By determining the value that specific groups attach to various financial and nonfinancial rewards, companies can develop reward strategies that meet organizational cost objectives and provide improved perceived value to employees.

Putting It All Together

Clearly, there’s plenty to take into account when it comes to addressing talent and reward programs in any economic circumstances. Costs can be cut in a variety of ways, but the risks to organizational performance — especially as a result of potential changes to employee engagement levels — will vary greatly depending on which decisions are made. That’s why it’s so important to pursue a holistic approach to rewards. The consequences of decisions are greater when times are bad, and the impact can extend well into the future. Getting it right now, across the board, will pay dividends down the road.

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About Towers Watson

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