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The modern firm: Benefits in a new economy

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Agenda

- Rewards in the new economy
- Total rewards framework
- Flexible benefits

Introduction

- Over the past few decades, the global economy has undergone profound changes.



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Introduction

- One of the most important developments has been the rise of the knowledge economy.



Introduction

- Within the knowledge economy, the value of human capital is clear.
- Corporate competitiveness is underpinned by the attraction and retention of the *right employees*.
- Human resources has an important role to play therein.
- Incentives and rewards are crucial.

Introduction

“The essence of the firm in the new economy is its ability to create, transfer, assemble, integrate, protect, and exploit knowledge assets. Knowledge assets underpin competences, and competences in turn underpin the firm’s product and service offerings to the market. The firm’s capacity to sense and seize opportunities to reconfigure its knowledge assets, competences, and complementary assets, to select appropriate organization forms, and to allocate resources astutely and price strategically all constitute its dynamic capabilities.”

David Teece

Introduction

- But there are pitfalls that must be avoided...



Photo by Jeff Auth

Goals and Objectives

- Conceptualize the “new economy.”
- Illustrate the changing dynamics of “competitiveness.”
- Highlight the important role of human capital in corporate success.
- Illustrate the utility of innovative reward structures in the new economy.
- Warn about potential pitfalls.

The New Competitive Environment - 1

- Since the Kennedy round of trade negotiations in the 1960s, we have seen a liberalization of product and labor markets around the world.
- Today, trade barriers no longer protect firms' competitiveness in certain jurisdictions.
- Deregulation has been an important trend as well, in particular in finance.
- Financial flows around the world are challenging inherited organizational traits (“The Financial Thesis”).
- Result: Traditional sources of competitive advantages have given way to a new paradigm of wealth creation.

The New Competitive Environment – 2

Trends and implications resulting from today's challenges



The New Competitive Environment – 3

- Firms in the West have transitioned from materials and manufacturing to the development, processing and application of knowledge.
- Transmitting information is almost costless.
- Payoffs come to firms that can rapidly spot and exploit new opportunities.
- Requires mechanisms of organization where decision making can be near-immediate and action swift.
- According to recent Nobel Laureate Oliver Williamson, corporate organization is an important determinant in innovation.

Human Resources

- In the knowledge economy, effective human resources are paramount for success.



Human Resources

- It boils down to a classic principal-agent problem:
 - The principal, typically the firm owner, wants to incentivize its employees to act on the principal's behalf and to use their human capital for innovation.
- In this regard, incentives are very important, and employees have been shown to respond to the rewards a firm offers.
- As such, firms need to consider how the working environment affects the behavior of their employees.
- Incentives and rewards can help in a number of ways.
- Case Study: Managing turnover...

Case Study: Managing Turnover

- Modern firms cannot afford to lose investments in employee skills; 'firm specific human capital' is particularly important.
- General human capital is not a problem, since it is (in theory) available on the labor market.
- The lower the turnover, the more an employee is willing to invest in skills that are firm-specific; the higher the turnover the more employees will invest in skills that can be useful at other firms.
- So, where is turnover appropriate? Where is it inappropriate? How can firms manage this using incentives and rewards?

Turnover – Retention

- Turnover becomes costly when individuals with high firm-specific capital leave.
- In order to retain these individuals, firms will utilize a series of strategies.
- Cash compensation is an option, but expensive; many turn to other rewards, such as benefits or deferred compensation.
- If you can't retain the employee, ensure that you can retain some of the knowledge created by the employee by asking employees to work in teams to ensure familiarization (at minimum) with one another's work.

Turnover - Screening

- Turnover can be good for an organization.
- High turnover rates may be a priority in industries where technology is advancing rapidly, requiring newly trained individuals or at least individuals with new insights and ideas.
- Increase workforce quality by screening more employees; useful for young employees without long track records.
- Examples of incentives or rewards used to achieve this:
 - Up or out contracts are very common in professional services firms (and academia).
 - Sales oriented firms will use commission based compensation schemes.



Rewards in the Modern Firm

- It is important to set up rewards systems correctly.
- It is extremely difficult to create rewards for creativity, which can make rewards systems in modern firms / the knowledge economy complex.
- In order to properly reward employees, you must first be able to accurately evaluate performance.
- Quantitative performance evaluations are difficult in this context.

Evaluating Performance

- Ideal: performance evaluations should evaluate the effect of a specific individual's actions on the value of the firm and nothing else.
- Looking to differentiate between those factors that are within the employees' control and those factors that are uncontrollable.
- Evaluations should be based on those factors that are controllable.
- So, performance evaluations must include both quantitative and qualitative assessments that drive rewards.

Rewarding Performance

- “Pay for performance”
- Edward Lazear and Michael Gibbs think effective rewards must have good answers to the following two questions:
 - What are the properties of performance evaluation?
 - How is this evaluation tied to the performance the firm is trying to incent?
- Case study: Profit Sharing

Types of Rewards

- So what types of rewards are modern firms using?
 - Salary
 - Bonus
 - Promotion
 - Options
 - Awards
 - Commissions
 - Overtime Pay

and

 - Benefits!



Case Study: Benefits in the New Economy

- Some reports show that employers today pay upwards of 25 percent of compensation on benefits.



Photo by AMagil on Flickr

What Role for Benefits?

- What are benefits?
 - Pensions, Health Care, Dental Care, etc.
- How are benefits being extended to match up with the new competitive dynamics in the new economy?
 - Concierge, employment insurance, etc.
- How do firms value benefits?
- How do employees value benefits?



Why Provide Benefits?

- The government says you have to, e.g., unpaid leave.
- Still, there are *profitable* reasons to offer benefits as part of a broader human resources strategy.
- Manage turnover.
- The firm can sometimes offer a benefit cheaper than the employees “value” (risk pooling, bulk discounting, tax benefits, etc.).
- Also, by giving employee discounts on the firm’s products, the employees serve as a first line of quality assurance and testing.
- For most firms, the largest benefit provided is the pension.

Beware of Pitfalls

- Rewards can have important implications for the profitability of a firm. However, they can also be a source of value destruction.
- In theory, rewards designed to enhance productivity should vary with the business cycle.
- During periods of growth, the firm might like to provide its top employees with certain benefits to make their long hours at the office easier. In downturns, these benefits would ideally be withdrawn.
- It isn't that easy. And past commitments oftentimes cause problems for the modern firm.

Case Study: Legacy Costs

- Michael Jensen taught us that many of the problems that modern firms face stem from an unanticipated escalation in “prior commitments.”
- Erica Schoenberger also illustrated how traditional rules, relations and expectations embedded over decades may impede the ability of the firm to react appropriately to changes in the competitive environment.
- Legacy costs are defined as past pension and health care promises to employees made by mature firms in the new economy.
- Legacy costs can be competitive drains for firms; they compound other problems by siphoning off much-needed capital that could otherwise be reinvested in the business.

It's All About Flexibility

- When structuring rewards for a firm in the new economy, it is important to ensure that flexibility is maintained.
- Note that in the new economy firms are engaged in a permanent struggle for survival in competition with others.
- Companies are increasingly facing market-mandated reorganizations of embedded organizational structures to remain competitive.
- As foreign and new-economy firms emerge as credible competitors to domestic legacy firms, inherited production and manufacturing practices are put in play, forcing these firms in effect to restructure or fail.

Principles for Success

- **Principle #1:** All about attracting and retaining the *right* people for your organization; 'fit' is crucial.
- **Principle #2:** How the firm is organized will have implications for its success.
- **Principle #3:** Performance evaluations need reliable assessments, which feed rewards that drive specific behaviors.
- **Principle #4:** In setting up rewards systems, flexibility is paramount; must hold onto dynamic capabilities.





Total Rewards Framework

Effective Total Rewards requires an integrated framework

Holistic

Not individual program decisions

Right mix of money (pay & benefits), careers, and work/life for our organization ... for our employees

Fact-based

Not based on anecdotal evidence

Allocate reward investments to achieve intended outcomes in terms of engagement, retention, productivity and results

Total Rewards



Well-communicated

Not left to employee self-service or chance

Communicate our HR programs proactively to facilitate the engagement of our employees

Effectively administered

Not piecemeal or difficult to access

Cost-effective and efficient manner by which our employees understand, accept and use

Total Rewards Framework

Holistic: Determining the right mix

Employer perspective...

Money		Work/Life	Careers
Compensation	Benefits		
Base pay	Retirement	Time off	Performance and accountability
Guaranteed “bonuses”	Savings	Wellness programs	Career opportunity and pathing
Short term incentives	Medical / Dental / Vision / Prescription Drug, etc.	Dependent care	Mobility
Long term incentives	Life insurance	Workplace flexibility	Leadership
Financial allowances	Short and long term disability	Non-financial and status recognition	Experiential rewards
Financial recognition programs	Accident coverage	Commuter programs	Talent development
Deferred compensation		Workplace facilities and perquisites	

Employee perspective...

Fixed pay	Secure retirement	Leave practices	Learning
Variable compensation	Protection	Flexibility	Opportunities

Total Rewards Framework

The big picture

What is considered part of the definition of Total Rewards in your organization?



Source: Mercer/WorldatWork Survey, 741 participants, conducted in Q1 2010

Developing a Total Rewards Strategy Perspectives

COST PERSPECTIVE

Can the rewards programs designed to support the desired strategy be provided at an **affordable and sustainable** cost?

- If not, how should they be modified to be financially viable?

EXTERNAL PERSPECTIVE

What are the labor and related rewards environments in which the **company competes**?

How do they influence or constrain rewards practices that the company may wish to adopt?

EMPLOYER PERSPECTIVE

- What are workforce needs in terms of structure, behavior, capabilities and performance?
- How should the rewards programs be designed and delivered in order to secure those workforce **outcomes**?

EMPLOYEE PERSPECTIVE

- What creates a compelling place to work in the eyes of employees?

What does or should differentiate it from competing employment opportunities?

How do employees place **value** on the current rewards package?

Developing a Total Rewards Strategy

Sample blueprint

	Compensation			Benefits			Work/Life and Careers		
	Base Pay	Annual incentives	Long-term incentives	Retirement	Health and Welfare benefits	Perquisites	Work/life balance	Performance management	Workforce planning/ Career Pathing
Role of reward element	Attract and retain; reward building skills	Reward individual, business unit and corporate performance	Link to shareholder value creation	Wealth accumulation	Personal risk management	Tax efficiency	Compelling place to work	Goal setting/ accountability	Adequate supply of talent
Competitive positioning	25th percentile	Base + STI = 75th percentile	Base + STI + LTI = 90th percentile	50th percentile	Leading edge design; 50th percentile	Market practices	Environment difficult to match by competitors	Support “build” talent strategy	Balance pay and benefits with career opportunities
Impact of positioning	Risk tolerance	Performance orientation	Rewards long-term growth	Facilitate orderly retirement	Desirable employer	Employment brand	Attraction and retention of qualified staff	Focused efforts	Support “build” talent strategy
Metrics	Acceptance rate turnover; appropriate skills	Business results	Stock price growth	Retirement income adequacy; financial management	Cost and value delivered	Cost; commitment index	Commitment index; turnover	Scorecard results	Percentage of outside hires

Developing a Total Rewards Strategy

Need for segmentation?

Type of Market		Emerging market	Moderate growth	Mature market
Role of compensation elements		<ul style="list-style-type: none"> Attract 	<ul style="list-style-type: none"> Attract and retain 	<ul style="list-style-type: none"> Retain
Comparator group(s)		<ul style="list-style-type: none"> Future business competitors 	<ul style="list-style-type: none"> Current labor competitors 	<ul style="list-style-type: none"> Current business competitors
Competitive positioning (including mix)	Target:	<ul style="list-style-type: none"> P90+ 	<ul style="list-style-type: none"> P50 	<ul style="list-style-type: none"> P25 – P50
	Base pay:	<ul style="list-style-type: none"> P50 	<ul style="list-style-type: none"> P50 	<ul style="list-style-type: none"> P25
	STI:	<ul style="list-style-type: none"> P75 	<ul style="list-style-type: none"> P50 	<ul style="list-style-type: none"> P75
	LTI:	<ul style="list-style-type: none"> P90+ 	<ul style="list-style-type: none"> P50 	<ul style="list-style-type: none"> P25
	Retirement:	<ul style="list-style-type: none"> P50 	<ul style="list-style-type: none"> P50 	<ul style="list-style-type: none"> P50
	Health & Welfare:	<ul style="list-style-type: none"> P75 	<ul style="list-style-type: none"> P50 	<ul style="list-style-type: none"> P60
Performance orientation	Differentiation:	<ul style="list-style-type: none"> Less 	<ul style="list-style-type: none"> Standard 	<ul style="list-style-type: none"> More
	Time horizon:	<ul style="list-style-type: none"> Long term 	<ul style="list-style-type: none"> Balanced 	<ul style="list-style-type: none"> Short term
	Measurement unit:	<ul style="list-style-type: none"> Group 	<ul style="list-style-type: none"> Individual and enterprise 	<ul style="list-style-type: none"> Individual



Flexible Benefits

What is Flex

Traditional vs. Flex Benefits

Traditional

- Employer decides on benefits
- Employer absorbs future cost increases
- Employees undervalue cost of benefits



Same benefits for ALL employees

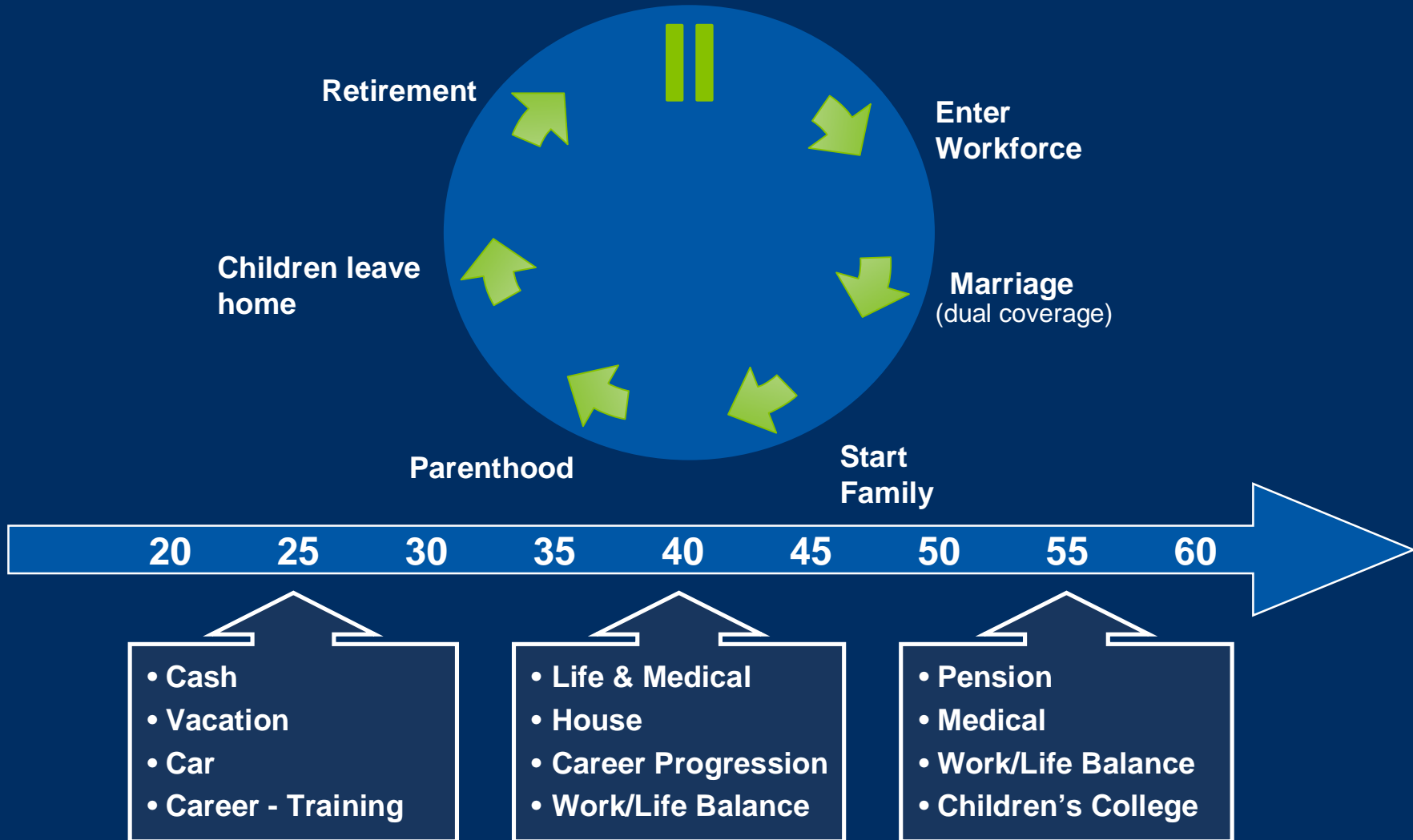
Flex

- Employees aware of benefits
- Employee co-shares any increases
- Employees understand employer costs



Employees choose the benefits that meet their individual needs

Employees have different benefit needs during different life stages

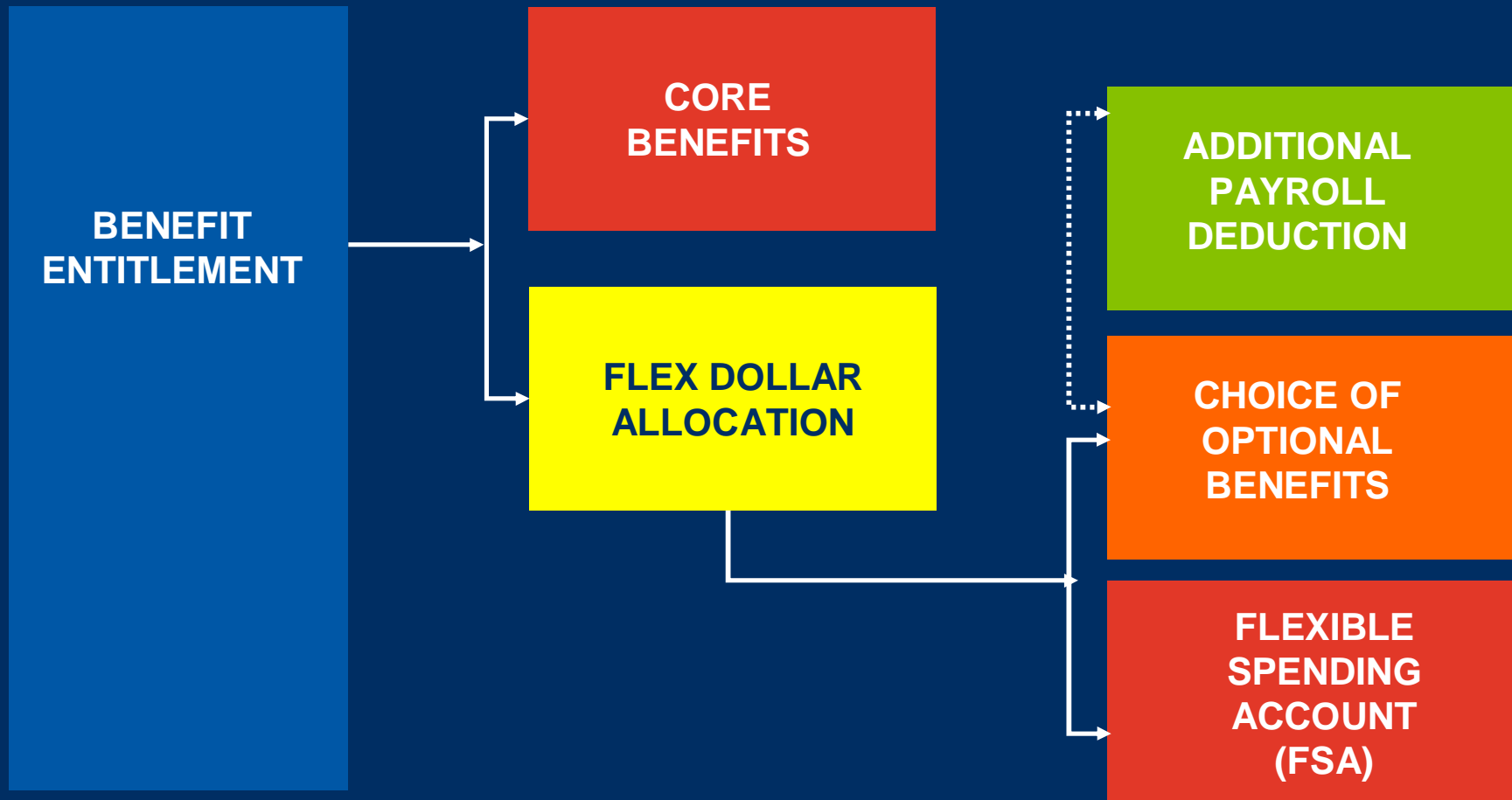


Drivers of Flex

- Meet employees' needs as workforce becomes more diverse
- Maximize value of benefit spend by offering employees the choice of how benefits dollars are spent
- Differentiate from competitors as employer of choice
- Control escalating benefit costs – increased employee cost sharing
- Harmonize benefits across entities or during M&A
- Communicate benefits as part of total rewards package – promote better understanding of costs and greater appreciation of benefits
- Facilitate benefit program changes

Typical Flex Structure Overview

Flex is a scheme which provides options for employees to choose the benefits which *best meet* their needs



Flex Terminologies

CORE BENEFITS

Core Benefits are the minimum benefits provided to employees each year. Employees cannot “opt out” of such core benefits

FLEX DOLLAR ALLOCATION

Flex Dollars (or Credits) are allocated to employees each year by the company. These are the spending dollars in the Flex Plan.

Optional Benefits are a list of options which employees can choose from each year depending on their needs. Each Optional Benefit comes with a price tag expressed in Flex Dollars

Flexible Spending Account (FSA) contains balance of Flex Dollars not used for purchase of Optional Benefits. Employees can submit approved expenses and will be reimbursed up to the balance in their FSA

CHOICE OF OPTIONAL BENEFITS

FLEXIBLE SPENDING ACCOUNT (FSA)

Typical Core Benefits

Some might be global, some local

Life Insurance	<ul style="list-style-type: none">▪ Minimum sum assured for employee
Hospital Insurance	<ul style="list-style-type: none">▪ Basic hospital plan for employee
Medical Outpatient	<ul style="list-style-type: none">▪ Sometimes basic medical outpatient plan for employee
Dental	<ul style="list-style-type: none">▪ None
Health Screening / Maternity	<ul style="list-style-type: none">▪ Basic health screening package for eligible employees▪ Basic maternity package for eligible employees / spouses
Other benefits & perks	<ul style="list-style-type: none">▪ None

Potential optional benefits offered as part of a Flex program

Wealth	Health	Lifestyle
<ul style="list-style-type: none">▪ Retirement plans▪ Savings plans	<ul style="list-style-type: none">▪ Insurance▪ Medical▪ Dental, Vision▪ Life▪ Disability▪ Personal Accident▪ Maternity▪ Health screenings	<ul style="list-style-type: none">▪ Leave▪ Childcare▪ Travel▪ Education▪ Transportation/car▪ Housing▪ Mobile phones▪ Gym membership▪ Tax/legal assist

Wide variation by country

Flexible Spending Account (FSA) – Examples

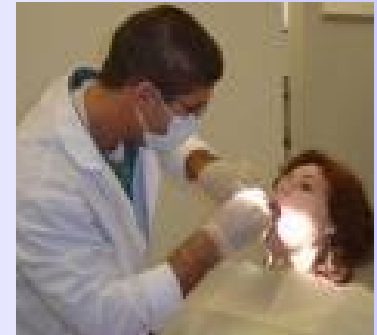
Reimbursement



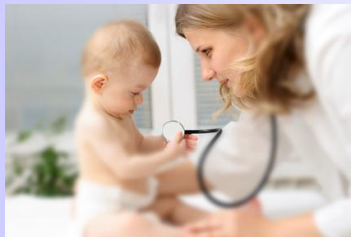
Health & Fitness



Chinese Herbalist/
Bonesetter / TCM



Dental



Childcare



Optical



Personal Insurance



Health screening

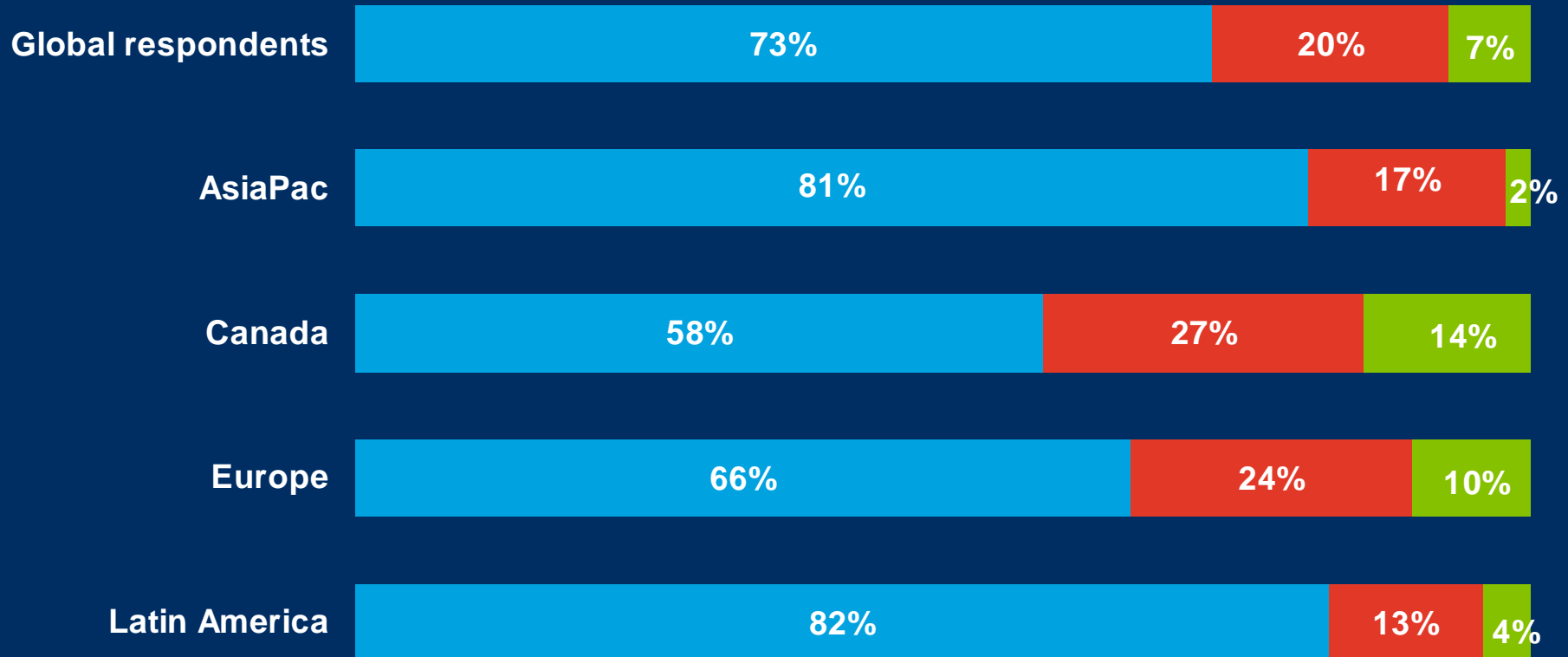


Vacation

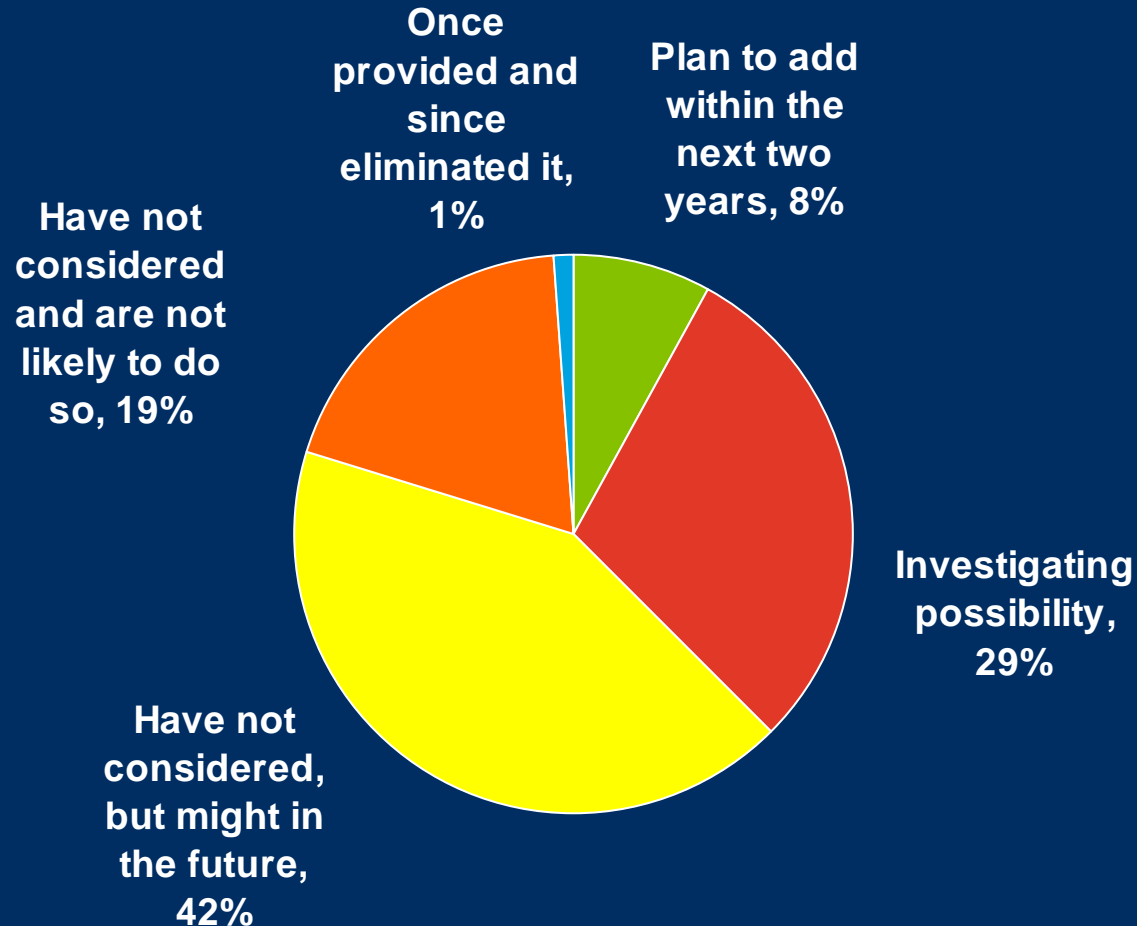
Balance of Flex Dollars after purchase of Optional Benefits are credited to each employee's FSA

Flex benefit programs are not yet widely spread...

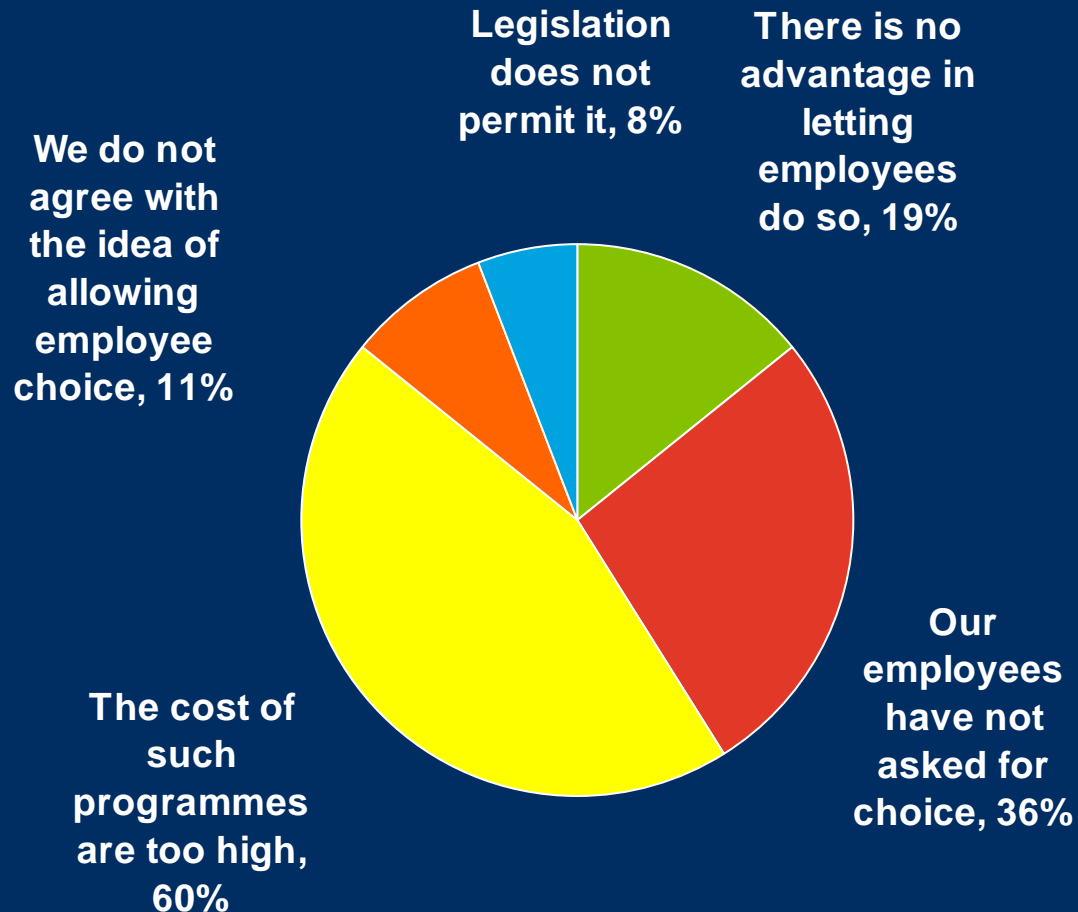
- No choice is offered
- Some choice
- A great deal of choice



Flex benefit programs are not yet widely spread... But often seen as of significant interest

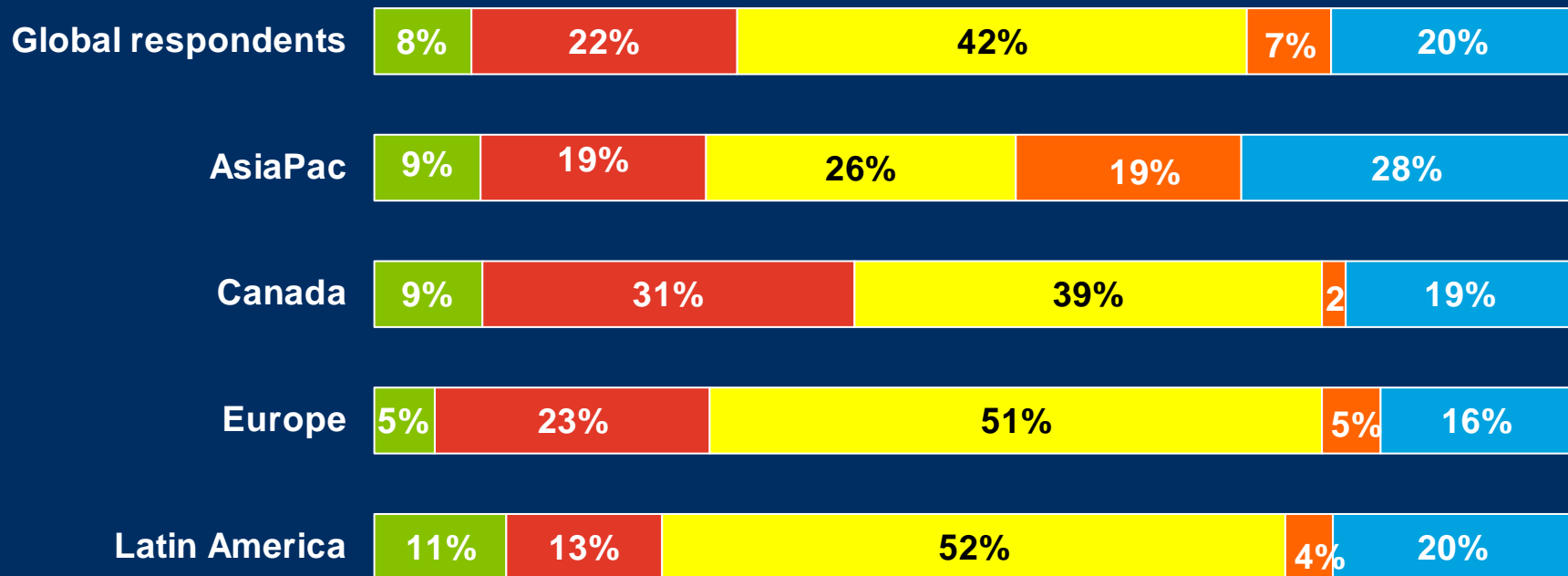


Reasons for not providing choice



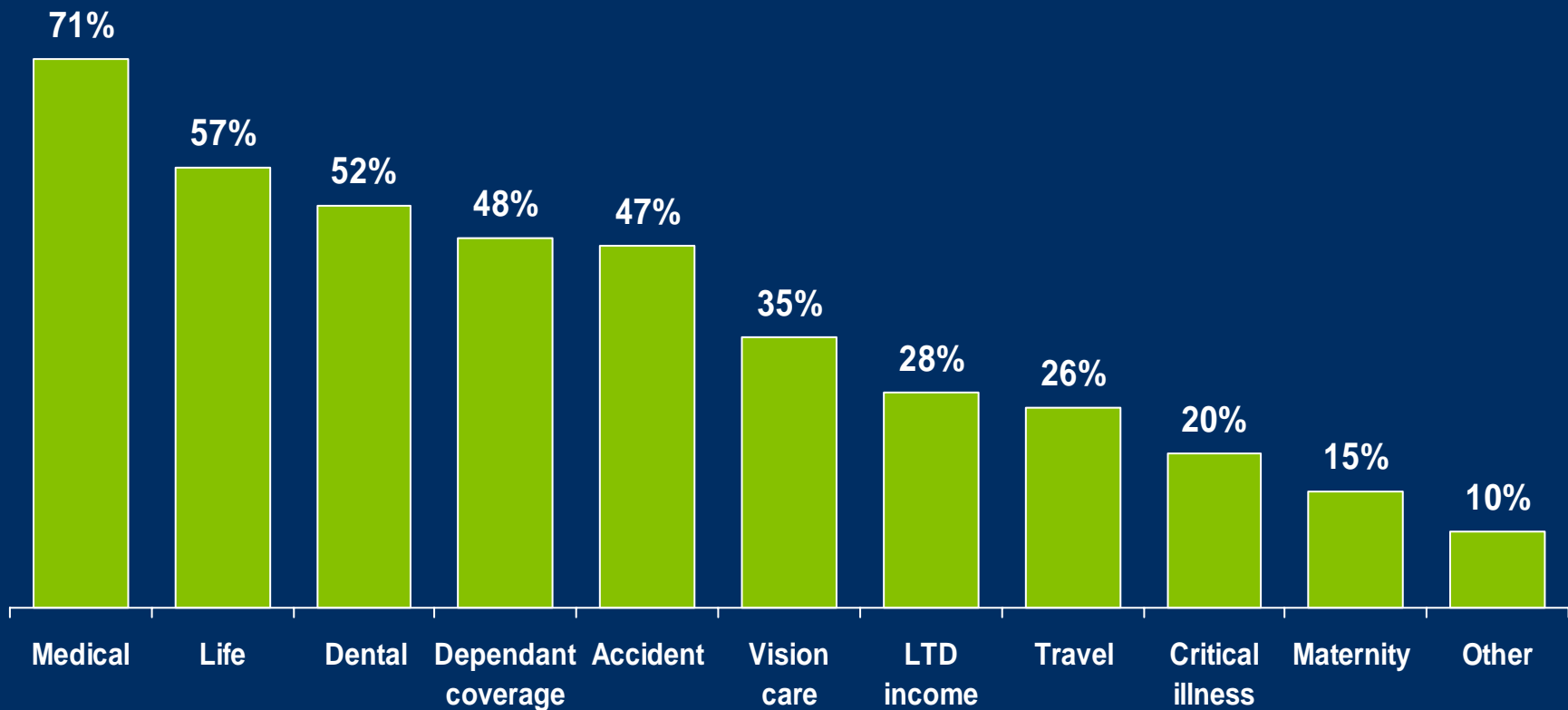
Impact of flex benefit programme on cost

- Cost is significantly lower
- Cost is somewhat lower
- Cost has been largely unaffected
- Cost is significantly higher
- Cost is somewhat higher



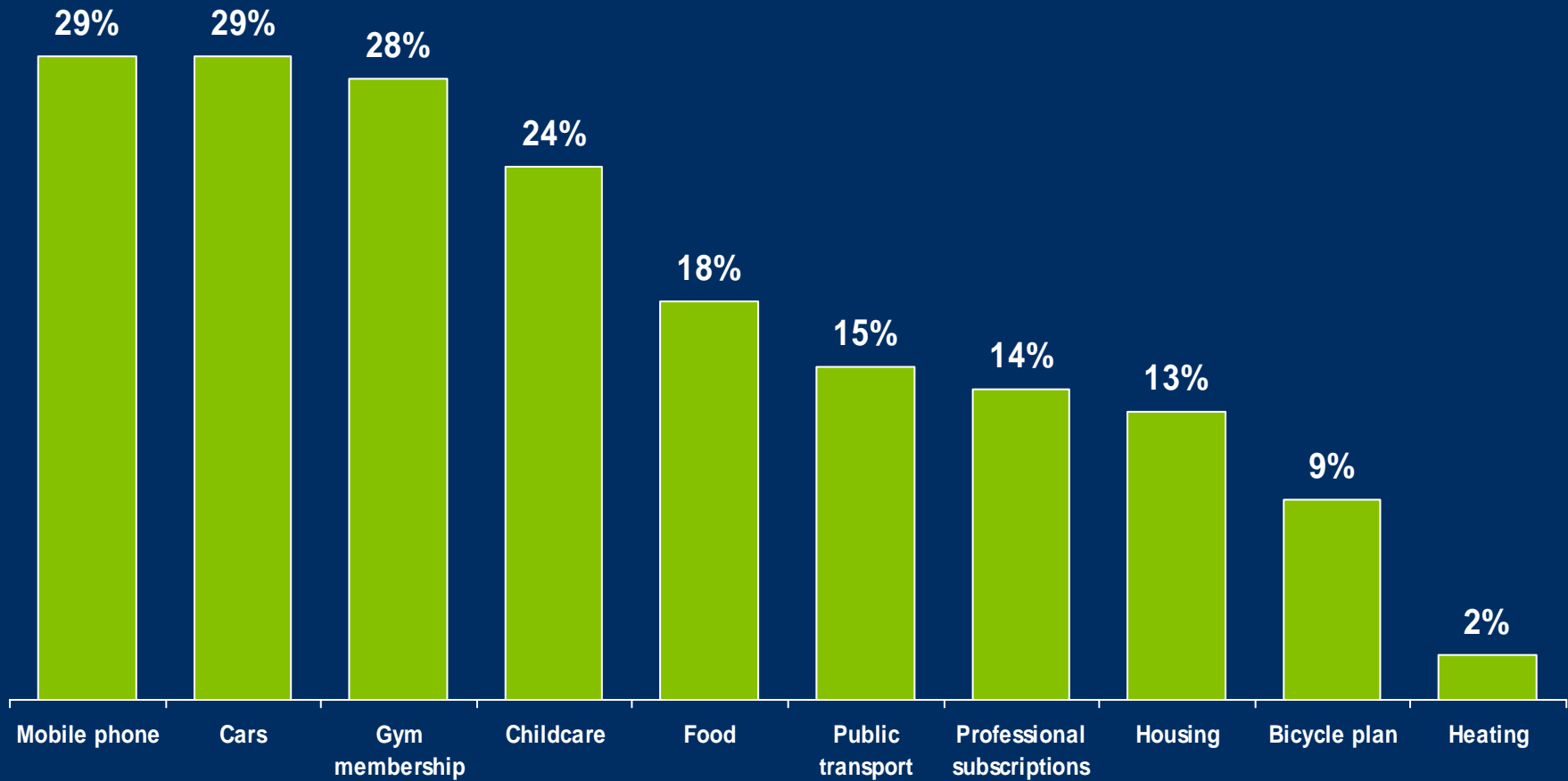
Insurance benefits offered through flex programs

Among respondents offering choices



Allowances offered through flex programs

Among respondents offering choices



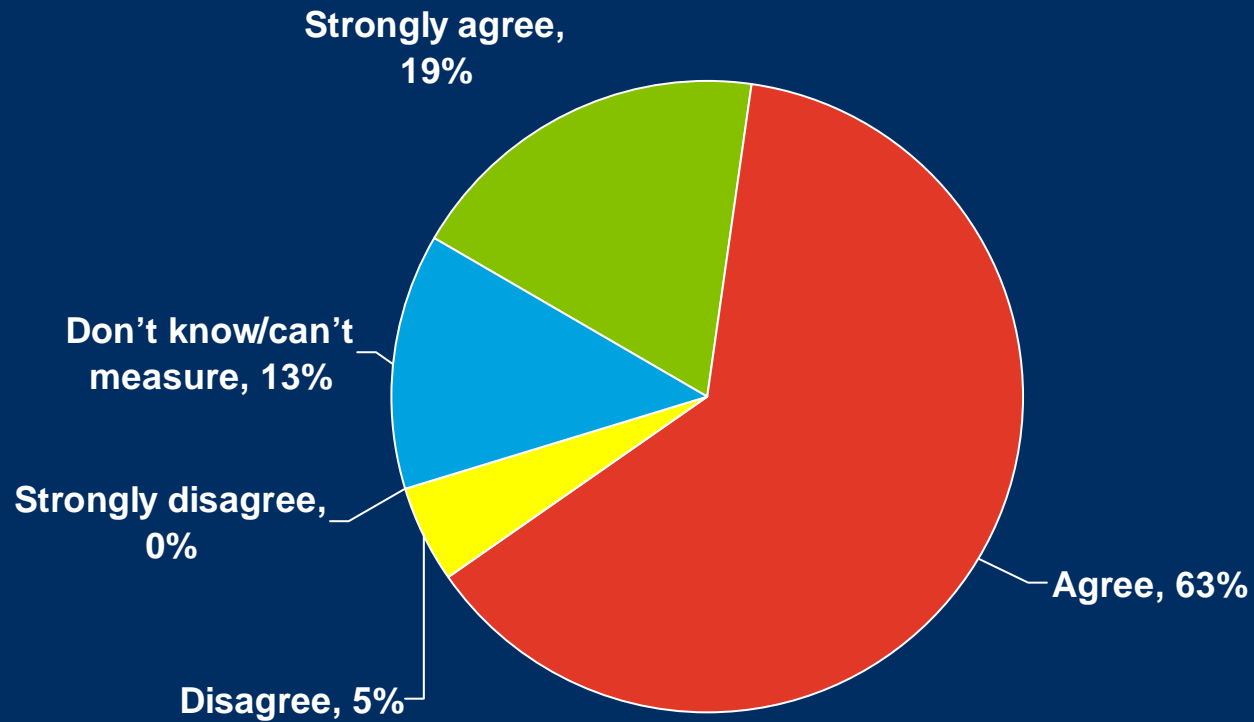
Other benefits offered through flex programs

Among respondents offering choices



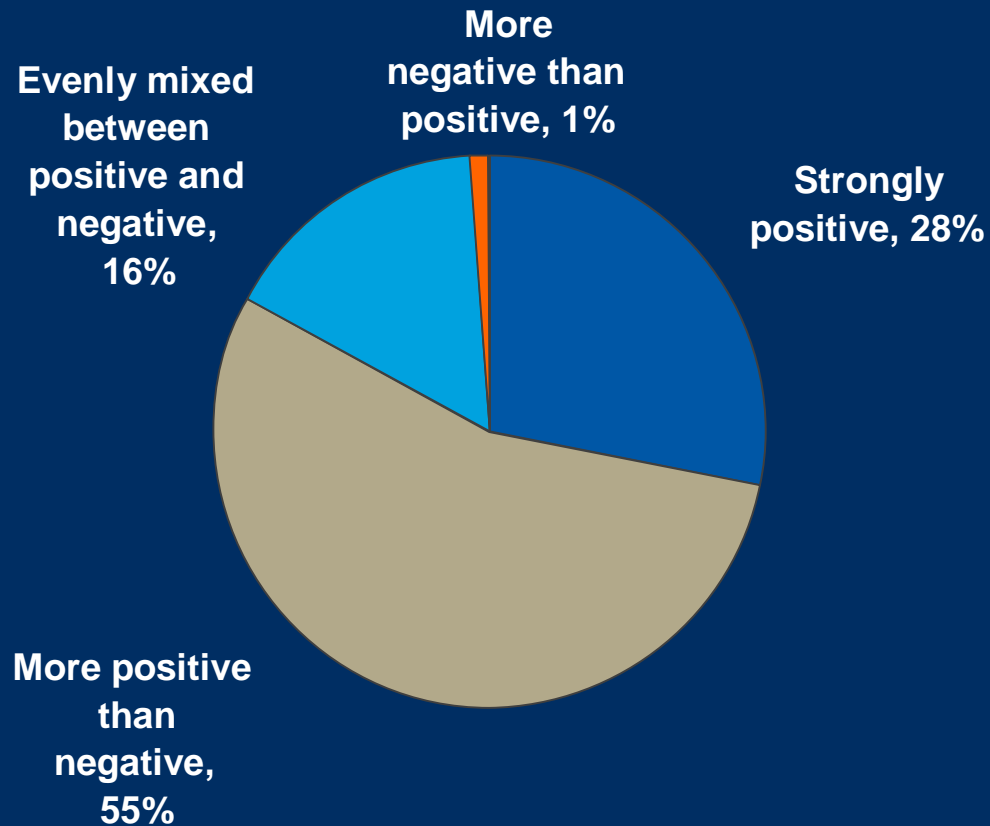
Employer opinion: Flex programs met objectives

Among respondents offering choices



Employee reaction to flex programs

Among employers offering choices



Market Prevalence of Flex

Strong Flex market



Global Prevalence of Flex

A few examples

Canada

- 50% currently offer or planning Flex next 2 years
- Popular options: medical & dental
- The trend is towards using health spending accounts as the vehicle to add flexibility. Spending accounts are becoming quite popular - both taxable and non-taxable

UK

- 60% surveyed offer Flex
- Favorable tax environment and national insurance terms
- Most employees' contributions exempt from NI contributions
- Trend to include employee pension in Flex

Mexico

- 20% of the companies have Flex
- Key drivers: Medical cost control, visibility of total benefits, harmonization, talent war
- Traditional benefits not meeting diverse employee demographic

Singapore

- Over 100 Flex plans already in place
- Mostly cover welfare plans. Flexible Spending Account popular
- Administration and communication are the main concerns of employers considering flex

Market Prevalence of Flex

Mid-size, growing Flex market



Market Prevalence of Flex

Only initial or no Flex market



Factors for a Positive Flex Environment

- Tax advantages of benefits
- Discount on prices and/or better underwriting conditions for benefits provided within employment
- A need to increase employee appreciation of benefits
- Labour market conditions
- Competitor's practices
- Ease of administration (e.g., data management) and lack of regulatory complexity (e.g., extensive tax documentation requirements)
- Industrial relations – view on benefits and their impact on employment by employers and trade unions/works councils
- Climate of open communication, individual responsibility and flexibility

Final Thoughts

- Large variation from country to country in how benefits are perceived and valued by employees
- Most programmes are developed and implemented on a local country basis
 - More organizations are taking a multi-country approach to ensure regional consistency, and leverage experience
- Key issues for the implementation and operation of flexible benefits :
 - availability of flexible benefit administration technology
 - government's role in providing and regulating health services and benefits
 - tax policies that impact both the employer and employee (e.g., deducting expense on a pre-tax basis, being taxed on the value of a benefit)
- Employee choice is on the agenda of many organizations, with many implemented in last two years. The economic downturn has not significantly changed planned implementations in next two years

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