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Draft report:

Overview of performance related pay options

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1. Introduction

Local authorities across the country are facing significant challenges at the present time. The government continues to implement austerity measures to deal with the country's budget deficit, and this has involved significant budget reductions for councils, which will continue for the foreseeable future. Councils face the challenge of striving to provide high quality public services with smaller budgets. Councils are scrutinising expenditure ever more closely, and aiming to ensure that all expenditure yields a productive return for local residents and stakeholders. As part of this, councils are increasingly thinking about the way they use the limited funds available for their pay reviews – seeking to ensure that scarce resources are allocated in the optimal way.

Harborough District Council has asked Hay Group to carry out a review of current reward practice. In particular, the support focuses on two areas:

- Benchmarking current reward practice against the external market, to determine market competitiveness and your actual pay position verses your policy position (you aim to pay at the median of the UK Public and Not for Profit market, excluding London)
- Considering options for introducing performance related pay in the future

In principle, the Council would like to reward employees in line with their contribution they make. You particularly want to ensure that you are customer-focussed, and promote a customer service ethos. You have asked us to outline a number of options for moving to a performance-related pay system to allow you to consider the advantages and dis-advantages of each, what would be involved in moving to the system, and the kind of annual pay review budgets required to make each option work. While performance related pay is still not widespread in the local government sector, increasing numbers of authorities are considering performance-related elements to pay, as they seek to develop their employment proposition, reward their top talent, and ensure that pay is linked to the contribution that employees make.

We have outlined three main options in this paper, and would be delighted to meet with you to talk through each of these options further, and answer any questions you may have.

2. Background to performance related pay

2.1. Purpose of performance related pay

The overall objective of performance related pay is to provide incentives and rewards which will improve the performance of the organisation by improving individual/team performance. To achieve this objective the aims of performance related pay are to:

- Motivate all employees to perform better – not only the high performers but also the core on whom the organisation depends;
- Deliver a positive message about the performance expectations of the organisation;
- Focus attention and endeavour on the key performance issues;
- Differentiate rewards to people consistently and equitably according to their contribution and competence;
- Help to change cultures where they need to become more performance and results orientated or where the development of other key values such as quality and customer service needs to be encouraged;
- Reinforce existing cultures and values which foster high levels of performance, innovation, quality and teamwork;
- Emphasise the importance of teamwork as well as individual contributions;
- Improve the recruitment and retention of high quality employees who will expect PRP as part of a well-managed working environment;
- Flex pay costs in line with organisational performance.

2.2. Elements of performance related pay

The main features associated with Performance Related Pay are:

Basis of the scheme – Individuals receive financial rewards in the form of increases to basic pay or cash, which are linked to an assessment of performance usually in relation to agreed objectives.

Consolidated pay increases – Scope is provided for consolidated pay progression within pay brackets attached to grades. Such increases are permanent and are seldom withdrawn (as in variable pay).

Cash Bonuses – High levels of performance can be rewarded by cash bonuses that are not consolidated and have to be re-earned. Individuals may be eligible for such bonuses when they reach the top of the pay bracket for their grade.

Pay progression – The rate and limit of progression through a pay bracket can be linked to individual performance. Depending on the system that is put into place this could represent a movement up the pay scale or a percentage increase payable for different performance ratings according to the performance rating.

Basis of pay progression – Pay progression in a graded structure is usually designed to decelerate through a grade. The reason for this is that pay increases should be higher during the earlier period when learning is at its highest rate. Secondly, it allows the organisation to manage people effectively against the middle of the pay range – which would be the Council’s policy position. Individuals below the mid-point should be able to get to that point if they perform acceptably. They can progress beyond that point, but only through sustained high performance. Such a system also serves to bring the pay of people performing at a similar level together over time.

Recognition schemes – Recognition schemes are schemes which pay out relatively small non-consolidated awards (usually cash or vouchers) for good performance on a specific piece of work. They are useful in providing a clear link to good performance, in quickly rewarding that good performance, and in the case of vouchers, are cost-effective from a tax perspective for the recipient.

Team performance pay – Linking bonuses to team, rather than individual performance. This is particularly useful when the behaviours you want to promote are collaborative, and where it is more appropriate to measure the contribution a team makes to the organisation, rather than an individual.

For team performance pay to be effective:

- It must align itself with the organisation’s core values and management style – the leadership will need to believe that good teamwork will make a significant contribution to the outcomes of the council.
- The characteristics of the team themselves should be appropriate for the form of pay chosen.

2.3. How performance related pay can add value

Hay Group frequently supports public sector organisations to reform their reward arrangements. Any serious review of reward policy should consider whether to link pay to performance and, if a connection is to be made, how it should be done.

This is a contentious subject. There are strong views about the difficulty of defining performance in the public sector and about public sector bonuses. At the same time, Will Hutton’s Review (Hutton Review of Fair Pay in the public sector, 2011, www.hm-treasury.gov.uk/indreview_willhutton_fairpay.htm) concluded that a fair pay system should relate pay to performance.

We believe that there are good reasons to believe that performance-related pay can add significant value to an organisation that is willing to invest in making it work. For example, some people say that public sector workers are not motivated by extra money. This may be true in many cases, but aligning pay to the priorities of an organisation, team or role can be a useful form of communication and reinforcement and makes pay more flexible. If an organisation pays the same money to people however they perform, it also sends a message. While some public sector employees may have had bad experiences with performance related pay, this does not mean that it is impossible to do better, and does not make the principle of rewarding employees in line with their contribution a bad one.

It is sometimes alleged that there is no proof that performance related pay works. In part, this depends on what it is intended to do (improve flexibility, communicate, recognise, actually increase performance etc). In addition, there is relevant evidence, for example in the work of David Marsden and Richard Bellfield (2006, Pay for performance where output is hard to measure: the case of performance pay for school teachers (LSE Research Online) and from Hay Group and Institute for Employment Studies research in the NHS (Reilly, Peter; Phillipson, Jane; and Smith, Peter (2005). Team-Based Pay in the United Kingdom, cbr.sagepub.com/content/37/4/54.abstract).

Here is some experience from one of our clients in local government who has implemented performance-related pay:

“Under nationally agreed terms and conditions you’re told what you have to pay people and then have to find the money. Opting out gives you complete control of the pay bill. We know exactly what it will cost us, and distribute what we can afford each year according to performance. If you mean what you say and demonstrate throughout you’ll do what you say, then pay reform is achievable. Although we encountered resistance, in the end we implemented a performance related pay system with no legal challenge. Performance related progression has helped us deal with poor performance. Since implementation we have seen a marked increase in those rated as poor performers leaving the organisation – suggesting it has helped get the message across that performance counts.”

Will Hutton’s Review of Fair Pay made a number of recommendations. Those particularly relevant to considerations around paying for performance include:

1. Ensuring robust remuneration governance, with oversight by a remuneration committee.
2. Develop and review a clear policy covering all aspects of reward for all roles.
3. Disclose the policy and pay practice at senior levels.
4. Monitor and explain the relationship between top and median pay.
5. Link reward to performance and avoid rewarding failure.

6. Create ways for employees to share in the rewards of success.
7. Link reward policy to wider workforce and management processes, including succession and talent management.

2.4. Other related people policies and processes

For performance related pay to be successful in delivering the objectives, it must be successfully aligned with other people processes, including the ones identified by Will Hutton. Of particular importance is equipping line managers to successfully manage the performance of their teams. Managers need to be clear about expectations and priorities, be able to effectively communicate these to their teams, provide honest feedback, and manage performance on an ongoing basis. This includes having difficult conversations and making clear, fair and consistent judgements about the contributions of individuals. If any performance-related pay system is to work effectively and add value, investment in management capability in this area is of paramount importance. We say more about this at the end of this paper.

3. Some high level options

At this stage, we have been asked to outline some high level options for implementing performance-related pay. There are many variations on these, but they provide a starting point for consideration. We have presented these below, starting with the most radical of the three.

3.1. A performance matrix and bonus scheme

Overview of the system

This option would likely involve withdrawing from national pay bargaining agreements and reforming your grade structure to produce a smaller number of broader grades with open pay ranges (as opposed to set incremental points which individuals can progress through). Each employee would receive a rating based on their performance that year. The overall pay budget would be determined by organisational performance and affordability. The pay rise each individual receives is then dependent on:

1. The performance rating awarded
2. The current position in the pay range

The largest increases would go to those receiving a high performance rating but who currently sit in a low position in the pay range. Conversely, individuals near the top of the range but only receiving a moderate performance rating would receive a much smaller increase. Individuals not delivering acceptable performance may receive no pay rise at all. An example of such a matrix is below:

	Low	Mid	High
High	0%	1%	2%
Mid	0%	2%	3%
Low	0%	3%	4%

The number of boxes in the matrix is dependent upon the level of granularity required, and the numbers in the boxes are determined by affordability and the number of individuals in each box. Clearly, given a set pay review budget, the reward for high performance will be smaller the greater the number of people with high performance ratings. That makes differentiating between different levels of performance particularly important.

Under this option, a set amount of money could be made available for bonuses based on organisational performance and availability. This too could be distributed based on grade and performance rating. The use of bonuses can be particularly useful as it reward good performance without building additional cost into the pay bill going forward, and provides a mechanism to align the total remuneration employees receive not only with their own performance, but with the performance of the organisation.

Advantages

- Provides a clear link between performance and pay – through both base salary and bonus
- Allows individuals to progress through the pay range in line with their contribution to the organisation
- Facilitates faster progression towards the middle of the band in the early years in a job, where learning is often at its greatest
- Allows individuals to reach a similar position in the range to those performing at the same level as them, over time

- Tends to result in salaries clustering around the middle of the range – i.e. close to your pay policy position – but leaves scope for high performers to earn more
- Use of the bonus allows the organisation to control costs – payments may be large in years of good performance, but need not be when it is unaffordable
- Facilitates the alignment of pay rises with affordability each year
- Provides greater flexibility in the recruitment and retention of staff

Disadvantages

- Requires significant changes in terms and conditions and probably, to the grade structure too
- If performance is not managed effectively, such a system can be very costly, or can result in little differentiation in pay
- Initial investment in developing the system and in training management
- Could be a significant shift culturally
- Requires a robust process for ensuring consistency in performance ratings
- Care must be taken to ensure there is sufficient motivation for staff already high in the pay range

Other factors to consider

For this option to work, there needs to be sufficient pay review budget available to allow significant differentiation in pay awards between high performers and poor performers. The reward for good performance needs to be sufficient to send the right messages and provide the right motivation. If pay review budgets are severely constrained, as many are in local government at present, this systems often results in additional complexity for limited benefit. For instance if the pay review budget is 1%, there is not enough money available to significantly differentiate reward for high performance with the rewards for average performance. That said, it could also be argued that it provides an opportunity to embed the right performance processes and behaviours before the amounts of money at stake becomes more significant.

3.2. Performance-based increments

Under this option, the Council could retain its existing incremental pay ranges, but individuals would progress up the range subject to meeting particular performance criteria. Some increments could be accessible through delivery of acceptable performance, whereas the higher points could be accessed through delivery of high performance. Crucial to making this system work is ensuring rigorous, fair and consistent assessment of

performance, and this must start with those at the top of the organisation. This system only works if some staff attain the incremental increases and others do not, or there is no differentiation based on performance.

Given that the Council has only four incremental points per grade, people could reach the top of the band relatively quickly. Therefore, a mechanism will be required to continue to provide a performance incentive for those at the top of the band. The most effective way to do this is often to offer a non-consolidated bonus to those at the top of the band but who achieve a high performance rating.

Advantages

- Does not require significant investment in a new grading structure
- Would be an amendment to a basic structure staff are familiar with, which may be less disruptive
- Could provide a stepping stone to a more radical option
- Would not require breaking away from the nationally-agreed pay spine

Disadvantages

- The Council does not have control over the size of the pay award – staff move up pre-set points. This can make budgeting more difficult.
- Care would have to be taken to ensure that things really did change. Our experience suggests that a number of organisations have introduced a requirement that staff achieve a certain level of performance before getting an increment, but everyone or almost everyone receives it. This is not performance related pay.
- If performance is not managed effectively, most staff will move to the top of the band very quickly.
- With many staff already sitting at the top of the pay band, this system will not offer many employees a way to improve their base salary, which may limit its effectiveness.
- There would need to be an initial investment to fund bonuses for those at the top of the grade who receive a high performance rating

Other factors to consider

The introduction of such a system, while less radical than the first option, is less likely to still require significant investment in management capability, and the development of a performance measurement system which stakeholders feel is fair and transparent. Money would also have to be found to fund the bonuses for those achieving high performance ratings but already sitting at the top of the pay range. The size of the bonuses would have to be significant enough to be motivational for people.

3.3. Changing the reward mix to introduce a bonus scheme

The final option presented is for the Council to retain its existing grade structure and incremental points, but to change the reward mix offered to employees. At present, the Council has a pay policy position of median on base pay, and does not make use of variable pay at all. Indeed, with the exception of the pension scheme, base pay makes up almost all of the remuneration package. People earn the same regardless of how they perform, and regardless of how the organisation performs. However, there may be an opportunity to change the mix of the reward offer made to employees and potential employees, as follows. The organisation could seek to benchmark total cash (base pay plus variable pay) against the market median, rather than focussing purely on base pay. As part of this, you could decide to offer lower base salaries, but introduce the ability to earn more through a bonus. Such an arrangement could be structured to ensure that someone delivering fully acceptable performance in a role was paid at (or close to) the market median when their base salary and bonus are added together. This bonus would be the target bonus. Someone failing to meet expectations would be paid less (base salary only). A high performer could earn more (base salary plus a larger bonus). Overall, if we assume a normal distribution of ratings, this may not cost the Council significantly more money, although many organisations find in practice that more people receive high performance ratings than a low one.

Advantages

- Provides a clear link between pay and performance – part of an individual's package is dependent upon doing a good job
- Facilitates this link without necessarily increasing the pay bill significantly
- The ability to earn more may be attractive for certain groups of staff, and these people may be particularly motivated to perform well and earn more
- Use of the bonus allows the organisation to control costs – payments may be large in years of good performance, but need not be when it is unaffordable

Disadvantages

- This is not an easy option to implement whilst tied to the current pay spine. Grades would have to be frozen and the pay review budget channelled into the creation of a bonus pool. This pool would therefore be very small in year 1, but would gradually increase to the desired level, at which point the grades could begin to move again. This could not be done under the existing agreement and would have to be separately negotiated. Such negotiations have the potential to cause significant disruption.

- Requires investment in management capability and an appropriate performance management system, including a mechanism for ensuring rigour and consistency in rating performance
- Base salaries alone may become less attractive than what is offered by other organisations in the area. There may be particular groups of staff that prefer a higher base salary and no bonus than the opportunity to earn a bonus. You may lose these people.

Other factors to consider

Like the other options, it would be important to consider this option in the context of the Council's overall approach to performance management, rather than in isolation. A change such as this has the potential to cause significant disruption and would have to be carefully managed. It would also have to be carefully designed to ensure a good return on investment, in terms of improved organisational performance.

4. Performance management

If it is to be successful, performance related pay must be just one element of a broader performance management process, which requires organisational performance targets to be carefully aligned with strategy, owned by senior management, and successfully cascaded through the organisation to the individual level. Implementing a performance related pay scheme without careful consideration of organisational context and culture, the strategy you are trying to deliver and the behaviours you wish to promote can result in a lack of impact at best, or incentivising destructive behaviours at worst.

To provide an idea of what would be involved in developing an appropriate performance model, we have outlined an example process below. Please note that this is an example based on a different organisation, not what we would necessarily suggest for Harborough District Council.

Design principles

- Simple, easy to administer, non-bureaucratic process.
- Up to six challenging targets including one development target.
- Targets and ratings to be discussed and agreed by senior management
- Performance to be rewarded through “increments for good performance

Targets

- Focus on clearly defined individual and team contribution.
- Targets should be linked to the strategic requirements of the organisation
- Identify and describe interdependencies; both internal and external.
- Need to be revisited during the year, and can be amended as a result of unforeseeable events.
- Must be equivalent challenge in targets for everyone.

Performance review

- Takes account of identified and/or unanticipated uncontrollable events.
- Takes account of whole job performance, linked to ongoing performance appraisal/management process.
- No “forced” distribution of ratings (i.e. not a pre-set number of staff that can achieve any particular rating).

Rating

An example of a five point rating scale could be:

- 5 – Far exceeds expectations
- 4 – Above expectations
- 3 – Meets all expectations
- 2 – Meet some expectations
- 1 – Does not meet expectations

Moderation

- Setting targets - Directors to share and test challenge of cross-section of targets.
- Senior management to test, challenge and agree ratings to ensure consistency
- Audit

5. The right option for Harborough District Council and the way forward

It is too early to state which option is best for Harborough District Council. The answer will depend on what you would like to achieve through the scheme, the level of investment you are willing to make (in performance management and the development of a performance culture), and the level of disruption you are willing to endure during the transition process.

Managing performance successfully involves setting priorities that are in line with the organisation's vision and objectives; strong leaders able to communicate the principles; middle leaders who understand and are enabled to implement the required processes; development of the processes and people; and holding to account. Hay Group has supported a number of Councils to develop their performance management and pay arrangements, and we would be happy to discuss options for implementing something in Harborough District Council if it is of interest.