Managers—The Missing Link in the Reward Change Process

Driven by economic and regulatory forces, many organizations are making wholesale changes in such employee rewards as equity compensation, retirement plans, and health care benefits. Any change in rewards can affect employee motivation and commitment, and poorly implemented reward change can have disastrous outcomes. Organizations must pay attention to all the factors at play—rational and emotional—by laying a solid foundation for reward change and involving managers throughout the organization. Supervisors and managers play an essential role in building a credible case for change and implementing change in a way that employees see as fair and reasonable.

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It is Monday morning and you have just arrived at work. You look around and see plenty of challenges—shoulder a heavy workload, innovate constantly, tend to your own development, contribute to a list of teams. Your organization asks a lot of you, and what do you get in return? Not an easy question to answer. If you scan your reward portfolio, you will likely see an array of elements in flux. In fact, of all the workplace changes occurring today, few traumatize employees more than the sweeping and seemingly unending restructuring of their rewards.

The vagaries of the economy and impending regulatory changes have prompted employers to modify their financial reward portfolios substantially. Consider these examples:

- Reeling from a five-year run of double-digit annual increases in health care costs, many organizations have reduced benefits and asked employees to share the financial pain. Employees have reluctantly accepted the reality that they must pay more for deteriorating coverage.[1]
- Forty-five percent of the employers (366 HR executives and managers) in a Towers Perrin study said they have either converted from a defined benefit pension plan to a cash balance retirement plan or will seriously consider conversion during the next two years. Employees have gotten the message: Of the 2,000 employees participating in the study, 60 percent thought their

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employers would ultimately reduce pension benefits and shift responsibility to employees, and 27 percent believed their companies would eliminate pensions.[2]
- As accounting rules evolve to require the expensing of stock options, many organizations have said they will reduce stock option eligibility or substitute other forms of equity compensation. For employees in the middle levels of the organization, this means that the opportunity to benefit from their organizations' equity performance will soon fade into memory, an artifact of the ancient 1990s.
- Human Resources departments continue to say that retaining and rewarding top performers is their highest talent management priority. Employees, however, remain skeptical: Only about 25 percent believe companies effectively tie pay increases and bonuses to performance.[3]

Reward change may be inevitable, but it does not have to devastate employee commitment.

A high-definition picture has emerged for employees: Companies want to slash reward expenses wherever possible; slow the growth of reward costs to less than the rate of gain in employee output; and shift both cost and risk from the organization to the individual. Meanwhile, there has been no letup in the demands placed on employees to be productive, creative, and dedicated. A predictable and depressing trend in employee morale has resulted. Only 17 percent of employees say they are both highly committed to their companies and highly engaged in their work; and just 42 percent believe their organizations' senior management has a sincere interest in employee well-being.[4]

Reward change may be inevitable, but it does not have to devastate employee commitment. Organizations that take a thoughtful, thorough approach to such change can emerge with both an improved financial position and an engaged workforce. We believe the critical factor in achieving this goal is the role of supervisors and managers. By recognizing managers' importance and influence and ensuring they have a robust part to play in the reward change process, companies will have the best possible chance of managing the economics of reward delivery while keeping employees focused on their work and concerned about the well-being of their organizations. Maximizing the contributions of managers in turn requires that organizations meet a set of critical requirements. These requirements, which we will describe shortly, lay the foundation for effective manager involvement in reward change.

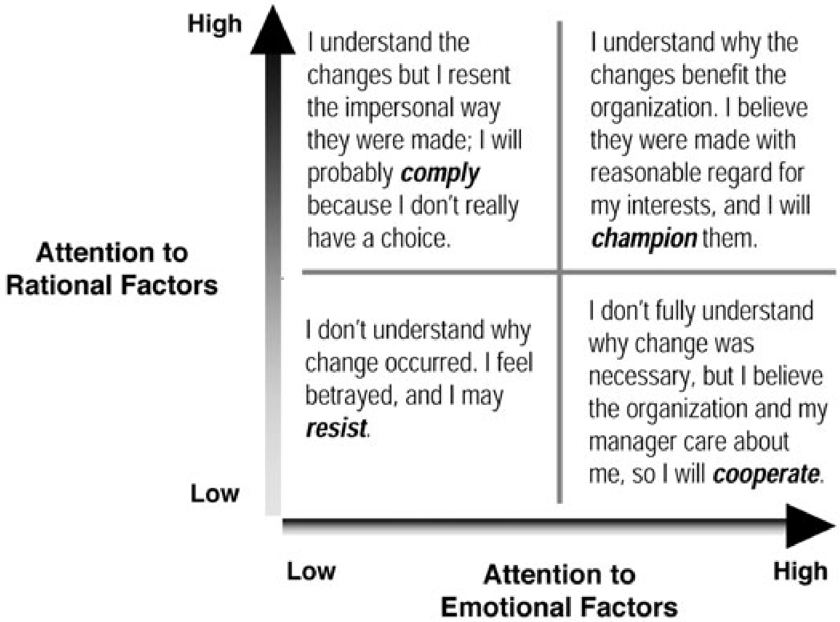
THE DYNAMICS OF REWARD CHANGE

In our observation, too many HR departments approach reward change as a two-step, one-dimension process: Create the right design and then communicate it. A Towers Perrin survey conducted late in 2003 asked HR managers and other executives to indicate which HR activities contribute most to meeting business challenges. The top three choices of the 265 respondents all involved program design, namely, (1) health care benefits, (2) "other" HR programs, and (3) compensation.[5]

Meanwhile, communication has largely become impersonal, a matter of pushing information to employees through an electronic pipeline. In Towers Perrin's 2003 survey of reward and performance management challenges facing 130 organizations around the globe, we found that 60 percent of the respondents reported a growing emphasis on, and investment in, technology for internal communication about rewards. HR departments now find themselves contributing to the tsunami of e-mail messages that threatens to swamp employees' desktops and erode the very productivity companies demand from their workforces. We also discovered that less than half of large U.S. companies use individual manager-to-employee sessions to convey how reward programs (and their evolution) link to business outcomes.[6] Leaving managers out of the reward redesign and communication processes dooms the change effort to failure.

In restricting its focus to reward design (or redesign) and electronic communication of the changes, the HR function overlooks an essential component of any successful change strategy: Change is possible only when organizations pay as much attention to the emotional and visceral elements (the *how* of change) as they do to the rational and intellectual elements (the *what* of change).

Exhibit 1. Employee Responses to the Rational and Emotional Factors of Change



The organization that launches a restructuring of its rewards envisions an upside benefit, typically lower direct or administrative costs. Employees generally experience the downside—lower financial value, higher risk, or greater effort required to manage their current or future well-being. When the downside becomes large enough, employees respond to their perceived losses with diminished commitment to the organization and less engagement in work. Reduced employee commitment and engagement in turn undermine the organization's earning ability through lower productivity, decreased customer satisfaction, and reduced product quality. Threats to earnings bring about another round of cost cuts, and the vicious circle continues.

When reward restructuring truly succeeds, it produces an upside benefit for the organization that is substantially greater than the downside loss for employees. To succeed, therefore, the reward change process must balance sensible design and efficient communication with awareness of and sensitivity to individual employee concerns.

Exhibit 1 illustrates the range of employee responses to how well—or poorly—their organizations attend to the rational and emotional aspects of change. As the graphic implies, employees can react to reward change in four different ways:

- *Resistance:* Quit the company; reduce effort; badmouth the organization internally and externally; abuse benefits.
- *Compliance:* Passively accept new reward programs; become resigned to the inevitability of changes; grumble about how much better things used to be.
- *Cooperation:* Go along with the changes; make reasonable effort to accept the conclusion that change was needed.
- *Championing:* Put energy into making changes work (for example, invest genuine effort to understand and aggressively pursue the goals expressed in a new incentive plan); tell others why change was necessary to make the company better.

Most organizations do a reasonable job of dealing with the rational elements of change. This is where the HR and organizational communication functions have the most to offer. Many companies fail, however, to address the emotional aspects. We often find that companies breathe a sigh of relief if their reward change efforts produce nothing more negative than compliance. They equate low organizational noise with success. We think they should aim higher and look for ways to inspire cooperation and even championing.

The rational and emotional (*what* and *how*) aspects of change are not entirely distinct— we know that they are inextricably bound. This puts an additional kink in the rational/emotional paradox of reward change. Daniel Goleman's well-known work in emotional intelligence has shown that emotions play an indispensable role in rational decision making. Emotions and the experiences that inform them streamline decision making by highlighting and helping us eliminate bad choices or move toward good ones.[7] Consider, for example, the increased likelihood that employees will accept a reward change if the organization has handled prior changes with fairness and emotional sensitivity. Conversely, if negative emotional experiences associated with past changes cloud their ability to listen, understand, and rationalize change, the chances for cooperation with change—let alone championing it—become slim indeed.

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The large majority of organizations, our experience suggests, fail to comprehend that they cannot fully meet employees' rational and emotional criteria without involving supervisors and managers. Front-line managers take on the daily challenge of creating productive environments for employees. The organization's reward design and communication experts must partner with them if reward change is to succeed.

CREATING A FOUNDATION FOR EFFECTIVE MANAGER INVOLVEMENT

To build the kind of partnership that we envision for successful reward reconfiguration (where the upside exceeds the downside), organizations must satisfy five major requirements:

- Establish a thorough analytical basis for reward change.
- Give managers information and build their skills to convey it.
- Consider rewards and reward changes holistically.
- Understand and respond to change management requirements.
- Ensure the reward change process is fair.

Addressing these five requirements gives managers a solid foundation on which to create a local environment that keeps people committed to their organizations and engaged in their work in spite of reward change.

Establish a Thorough Analytical Basis for Reward Change. Given everything at stake in reward change, there is no room for guesswork. We were reminded of this during a project with a large clothing retailer that had experienced high turnover in its network of stores. Some members of the benefits department reasoned that because employees care about their health, welfare, and lifestyle benefits, a wholesale redesign to enrich those benefits would reduce turnover. They had collected no actual data to support their conclusion, nor had they considered whether some other reward change (expanded training opportunities, for example) might have a more positive impact on turnover. Fortunately, the head of HR declined to make dramatic benefits changes solely on the basis of assumptions and mind reading. Instead, she commissioned a rigorous analysis to determine how employees valued each component of their reward portfolios. The analysis confirmed that while store employees certainly do appreciate their benefits plans, other rewards more directly influence the decision to remain with or leave the organization. Scheduling flexibility, merchandise discounts, and learning opportunities created by store managers dwarf health benefits as turnover factors for this young, largely part-time workforce. The analysis guided the retailer to shift emphasis (and incremental funding) away from benefits and toward other reward elements. The company thereby avoided spending tens of millions of dollars for no discernable reduction in turnover.

Give Managers Information and Build Their Skills to Convey It. A pharmaceutical client of ours planned to make changes in its incentive plan and the performance management system that supported it. Too often organizations simply direct employees to go to a page on the company intranet to learn about the changes to a reward program or to call an HR rep if they have any questions. This company, however, understood that employees would much rather get the information (especially about the new performance appraisal process) from the managers who would have responsibility for making the process work fairly and equitably. The company put together a thorough manager toolkit—and backed it up with extensive training—to prepare managers to (1) explain the new performance management and incentive systems accurately; (2) anticipate and answer employee questions; and (3) know where to go for detailed process and design information.

To respond to the reality of employees' reward portfolio perspectives, senior executives must require cross-unit cooperation within HR.

Sometimes the kind of analysis performed by the retailer in our earlier example can point to reward communication or administration problems that affect employees' perceptions of a reward element. Managers need this information to deliver rewards effectively. For example, our analysis of reward valuation and trade-offs for an insurance company client found that employees paid little attention to the organization's performance incentive plan. The analysis indicated they would be indifferent to even sizable increases or decreases in potential incentive opportunities. Even more striking, high-performing employees expressed as much indifference to the supposed performance-encouraging aspects of the incentive plan as did average and below-average performers—a disturbing finding for an organization that wanted to restructure rewards to enhance the performance focus of its culture. But the organization expanded its thinking about what might be undermining the current incentive plan. The company is now assessing whether the problem comes from flawed design, poor communication, or supervisor failure to administer the plan appropriately. The assessment will give managers and HR alike the information they need to increase the performance orientation of a new plan.

Consider Rewards and Reward Changes Holistically. We find that organizations often base reward program changes on the misguided assumption that people view each reward element in isolation from all others. The truth about employee reward perceptions is more complex than this. Social scientists who study employee attitudes have observed that employees view their reward portfolios holistically, forming generalized impressions about how much the organization values their contributions and cares about their well-being.[8] In a sense, they make a rational assessment of reward value and then bridge to an emotional conclusion about how well the organization demonstrates concern for their welfare. As we noted earlier, people also show willingness to make trade-offs within the portfolio; they will try to increase their overall portfolio value by agreeing to give up part or all of a relatively low-value reward for something with greater perceived worth. Towers Perrin's worldwide study of reward and performance management challenges found that in spite of this willingness, only 25 percent of U.S. companies said they currently try to identify and introduce trade-offs within the reward portfolio as part of their effort to reduce reward-related costs.[9]

One reason for the failure to approach rewards holistically is the tendency of HR departments to limit their vision of reward design changes to the boxes that make up the HR organization chart. The benefits unit looks for ways to reduce or transfer health care insurance costs, unaware of—or unconcerned about—the compensation group's plan to reduce expense by shifting emphasis to the incentive plan. Meanwhile, the retirement team is busy producing a pile of spreadsheets to figure out how much the organization can save by shifting to a cash balance plan.

To respond to the reality of employees' reward portfolio perspectives, senior executives must require cross-unit cooperation within HR. Cooperation among HR disciplines reduces the likelihood that reward design changes will become isolated within the borders of individual HR units. Piecemeal changes suggest to employees that reward restructuring is irrational and uncoordinated. Forging connections among the HR units responsible for reward change helps avoid this chaos. The one-two combination of coordination and thorough trade-off analysis increases managers' and, consequently, employees' confidence that the organization understands how employees view and value their reward portfolios. A reward change that seems rational to both managers and employees is a change that both groups can understand, embrace, and even champion.

Exhibit 2. Intensity of Attention Required in Charge Efforts

Required Intensity of Organization's and Managers' Attention

	Low	High
Source of Change	**Locally or individually initiated** Example: Reshuffling customer accounts between sales representatives	**Organizationally imposed** Example: Major restructure of incentive system
Pace of Change	**Slower** Example: 12 months or more to adapt	**Faster** Example: Immediate change
Direction of Change	**Neutral/Positive** Example: Trade-off of equally valued reward elements	**Negative** Example: Reduction of highly valued earning opportunity
Magnitude of Change	**Low** Example: Same net financial outcome	**Moderate/High** Example: Significant net negative financial outcome

Understand and Respond to Change Management Requirements. Modification of reward systems is a form of organizational change. Sometimes employees experience the reward change as relatively benign—a modest increase in medical copays, for example. Other forms of change can be both dramatic and traumatic—for instance, elimination of stock options for most employees. Across the range of possible reward changes, four major factors, shown in **Exhibit 2**, will determine the intensity of attention that organizations and managers should pay to the change effort.

When we refer to intensity of attention at the top of Exhibit 2, we mean such considerations as

- Frequency of messages about the changes
- Amount of anticipatory information provided (as opposed to information given in response to questions)
- Time and effort spent in communication by executives, HR, and managers
- Amount of effort expended in reaching out to employees to elicit their concerns (rather than waiting for questions)
- Speed of response to questions and new issues as they arise

One professional services organization we know introduced a significant strategic refocus accompanied by a reward change. Responding to competitive pressure and evolving marketplace needs, top management announced a shift in emphasis from business unit profitability to profitability of individual client accounts. This constituted a fundamental redirection in the way the company approached the market and rewarded people with responsibility for revenue generation and client satisfaction. The change called for a moderate to high intensity of organizational and managerial focus.

The firm engaged in a comprehensive array of broad change management efforts: It announced the rationale for the new focus; shared the research results that informed the change; conducted employee meetings to explain its likely implications; and educated people on how client profitability would be defined and measured. Key client relationship managers also had the opportunity to respond to the suggested changes—for example, by proposing modifications to the client profitability reporting. Though the change was chiefly intended to strip away administrative layers and focus productive consultants on the market, everyone knew that the ultimate reward implications could be significant.

This change management foundation addressed many basic questions and assuaged employees' more dramatic concerns. Most importantly, the organization successfully attended to both the rational and the emotional aspects of change. This freed managers to concentrate on championing change by translating broad reward and organization redirection into a set of local initiatives—and to do so even before precise performance metrics and incentive calculations were finalized. Managers reached across formerly rigid business unit boundaries to formulate and execute more comprehensive and economically disciplined account-by-account strategies. They created sales teams with representatives from multiple service lines; and they increased the discipline with which sales teams pursued client opportunities as a way to reduce sales and delivery costs and increase client account revenue. These organizational mechanisms in turn gave employees the means and confidence to meet the new performance expectations—and to fully embrace the new rewards structure.

Ensure the Reward Change Process is Fair. The word *fairness* conveys a sense of innocence, even naiveté. It is laden with emotional content. Children cry "not fair" when something they do not like happens—going to bed earlier than they want, not getting a second helping of dessert, taking out the garbage when they would rather be playing video games. Their complaints focus not on the reasonableness of the result—with which they disagree—nor on the equity of the process—often parental fiat—but on whether the outcome pleases them. In organizational life, we try to define fairness partially on process, partially on individual outcomes, and partially on notions of consistency, justifiability, and equality across people and groups. As adults, we may consider an event to be fair in spite of a negative individual effect.

Social scientists divide fairness into three separate forms, which we define here in the context of reward change:

- *Procedural Fairness:* The perceived equity of the processes by which rewards are allocated or reward systems are changed. Procedural fairness addresses the stepwise mechanics of change and therefore falls in the rational realm.
- *Distributive Fairness:* The degree to which an outcome conforms to the individual's personal sense of worth or deserving. Distributive fairness depends on the results produced by the change effort.
- *Interpersonal Fairness:* The consideration, respect, and sensitivity people receive when rewards are delivered or changes made. Interpersonal fairness reflects how people experience the emotional content of personal treatment they receive during and after the change process.[10, 11]

Procedural fairness addresses the stepwise mechanics of change and therefore falls in the rational realm.

Can fairness really serve as a practical change criterion in a world where advocacy and self-interest, not altruism and generosity, often dominate relationships between individuals and organizations? We think the answer is yes. We believe—and evidence indicates—that adopting fairness as a requirement for reward change improves organizational performance.

Among the three forms of fairness, organizations in general have the greatest influence over procedural fairness. Procedural fairness, in turn, most directly addresses employees' need for a rational change process. People consider reward changes to be procedurally fair when the changes

- Are applied consistently across time and people
- Remain free of bias, i.e., no third party has a vested interest in the outcome
- Are based on accurate information
- Incorporate a mechanism to correct flawed or inaccurate decisions
- Conform to reasonable standards of values, ethics, and morality
- Take into account the opinions and suggestions of the people affected by the decision or change[12]

Straightforward as the six procedural fairness criteria seem, organizations routinely violate them when making changes in reward programs. Consider, for example, the recent case of SBC, the telecommunications giant. In May 2004, SBC made two simultaneous announcements, that (1) retired union workers' copayments for doctor visits and prescriptions would rise significantly, saving the company nearly $400 million annually, and (2) corporate directors would receive as much as $10,000 each in free services, including telephone, wireless, Internet, and satellite TV services.[13] Did employees and retirees consider this one-two punch of reward changes procedurally fair? Here is how one SBC retiree reacted: "It's an insult. These [corporate directors] are guys who have never climbed a pole. They have never gotten up at three in the morning" to fix a downed telephone line. The retiree's reaction points out an obvious case of inconsistent treatment of different groups, a violation of the first procedural fairness criterion. Galvanized in part by the perceived unfairness, SBC employees staged a four-day strike to make it clear to management that they had no intention of allowing similar changes to their own benefits plans. In effect, they took it on themselves to invoke the fourth and sixth fairness criteria—having ways to correct and influence changes.

To ensure that ongoing analysis incorporated accurate financial data, the organization compiled an extensive database of reward cost information.

In the absence of procedural fairness, managers find themselves in the unenviable position of supporting changes that they—and their employees—resent and may not even understand. Indeed, if managers feel they cannot champion reward change, then employees will almost certainly resist it, with obvious implications for productivity and service quality.

Reward change does not have to create such a profound sense of unfairness, however. The case study that follows showcases an organization we worked with that made fairness the centerpiece of a dramatic reward change process—and reaped gratifying results as a consequence.

MAKING ALL THE RIGHT MOVES

In the wake of the 9/11 disaster, a major airline felt intense pressure to cut cost. Inevitably, its management team concluded that health care and retirement benefits for the organization's tens of thousands of active employees and retirees had to be on the table for reduction. The organization has a reputation for providing generous benefits programs; indeed, the company had not done a comprehensive review of benefits programs for some 30 years. By the spring of 2002, however, the time had come to look for drastic cuts.

The process used by the company encompassed all the fundamentals we have discussed for building a solid foundation for successful reward redesign and implementation, including most of the requirements for procedural fairness. To ensure that ongoing analysis incorporated accurate financial data, the organization compiled an extensive database of reward cost information. Human resources also conducted a sophisticated employee survey that gave all current employees the opportunity to indicate their preferred trade-offs among benefit elements in their reward portfolios. This approach not only enhanced the fact base upon which decisions would be made but also ensured that the opinions of the affected employees would be considered. Once company management had identified the potential benefit changes, Towers Perrin conducted some three dozen employee focus groups to test employee reactions to the changes, most of which were reductions in benefit levels or increases in employee costs. The focus groups gave employees the opportunity to provide additional input and guide management to correct any misguided or particularly inappropriate decisions.

As part of the change process, the airline's executives and local HR reps traveled to the 20 U.S. airports with the largest employee populations and held meetings to review the general elements of the anticipated reward changes. Department managers also conducted telephone conferences so that employees could ask questions. The company created an intranet site to provide basic background information about the changes and answers to frequently asked questions.[14] Subsequently, the airline provided employees an on-line modeling tool to let them compare their benefits under the old and new plans.

Ultimately, most of the changes implemented were less drastic than employees had feared, but a few changes were dramatic: Restructuring of the retirement plan, for example, will reduce costs by about $500 million over the next few years. As difficult as the changes may have been for some employees to accept, the fairness of the process ensured that the changes were perceived to be free from bias and consistently applied—everyone shared the pain in reasonable proportion. Furthermore, managers and employees alike accepted the changes as both necessary and reasonable given the company's financial reality and stated values of providing security to employees and retirees. Had the process for achieving these savings not met standards of procedural fairness, the dissatisfaction and morale-killing effects would have jeopardized the organization's ability to survive its financial challenges. Managers would have had a much more difficult time keeping employees focused on their work and dedicated to the survival of the company.

THE MANAGER'S ROLE IN IMPLEMENTING SUCCESSFUL REWARD CHANGE

The five fundamental requirements just discussed—establishing a sound analytical foundation, giving managers information and building their communication skills, considering rewards holistically, recognizing change management challenges, and ensuring a fair process—prepare the organization for reward change in two ways. First, they begin to address the range of both the rational and emotional issues at play. This helps to elevate employees' responses from resistance to something more positive. Secondly, they set the stage for managers to take actions that will help employees to experience the change process as reasonable and fair in both execution and outcome. The larger the change, the greater the potential damage to employee commitment and engagement—and the more critical the manager's role.

Managers can contribute to a successful reward change effort in three significant ways:

- Participate in reward system design and restructuring.
- Reestablish an energizing deal.
- Demonstrate individual fairness.

Participate in Reward System Design and Restructuring. When it comes to the development of reward programs and supporting performance management systems, the HR function rarely thinks of line managers as partners in change. Indeed, few organizations pay much attention to how managers as a group rate their satisfaction with the reward systems they must administer: Only 20 percent of the respondents to Towers Perrin's global reward survey included manager satisfaction measures in the evaluation of reward program effectiveness.[15] The exclusion of managers might be an artifact of more than a decade of downsizing and general dismissal of managers as bureaucrats and impediments to change. Whatever the cause, we think this attitude needs to change.

Employees see respect for their managers' contributions as an element of procedural fairness and a favorable reflection of the organization's character.

Why should organizations involve supervisors and managers in reward systems design? Shouldn't this fall solely within the domain of HR experts? We don't think so. First, managers know how people perceive their rewards and how changes will likely affect employee behavior. Soliciting managers' input taps this key source of practical insight about how performance management and reward systems will actually work once implemented. Second, inclusion helps address managers' own emotional concerns about reward changes, which are likely to affect them as well as their employees. Third, inclusion elevates managers' status in the eyes of employees, giving managers added credibility that can further enhance their effectiveness in implementing reward changes.[16] Employees see respect for their managers' contributions as an element of procedural fairness and a favorable reflection of the organization's character.

The airline discussed in our earlier case study went out of its way to include managers in designing reward changes and in communicating and implementing them. The HR function conducted a series of focus groups to obtain managers' input about employees' likely responses to changes in their benefits package. Managers predicted, for example, that employees would more readily accept changes if they had the opportunity to customize a benefits package—even one with reduced features or a higher cost for employees—to meet their individual needs. Managers also told HR that employees would likely be willing to pay out of their own pockets to keep the major elements of their current benefits package. The manager focus groups also presented two caveats. First, they cautioned that many employees did not fully grasp the nuances of some elements in the current benefits offerings (survivor benefits or Social Security offsets in the retirement plan, for example). Second, the managers warned that because everyone had been told the company was pulling out of its post-9/11 financial dive, employees would not understand why they were being asked to accept benefits cuts or cost increases now. HR took this advice to heart, incorporating much of what managers suggested in the final reward change design and rollout process. Manager involvement had contributed to HR's understanding of both the rational and emotional landscape they would face in implementing major benefits restructuring.

Ownership behavior grows with increases in commitment to the company and engagement in the work that makes the organization prosperous.

Reestablish an Energizing Deal. The manager plays his or her most critical role when reward change significantly reduces the perceived value of an employee's reward portfolio, as so often happens these days. Sometimes the organization can restore a portion of the lost value by moving money to programs that employees, through surveys or other mechanisms, have signaled as acceptable trade-offs. For example, a company might take some of the savings from cuts in health and welfare benefits and reinvest them in learning and development opportunities, provided employees have said these have a high value to them. In many ways, however, the manager has greater power than the organization to rebalance an individual's rewards array and thereby reestablish at least some of the perceived value lost through restructuring.

Consider stock options as an example. We never cease to be surprised at the number of organizations that believe stock options and equity ownership engender feelings of psychological ownership. Indeed, the goal of inspiring employees to act like owners drove widespread use of stock options in the 1990s (aided, of course, by accounting rules that kept option grants largely off the financial statements). However, Towers Perrin's research shows that stock options, like pay and benefits more generally, do not strongly influence the feelings of work engagement that drive ownership behavior.

What precisely does "ownership behavior" mean? As most companies intend it, ownership behavior appears when employees go beyond the formal boundaries of their jobs and do what is necessary to make their businesses more successful. Employees who act like owners identify with the company and take what actions they must to protect the organization's interests and ensure its prosperity. Ownership behavior grows with increases in commitment to the company and engagement in the work that makes the organization prosperous.

While stock options and other forms of equity compensation increase employee ownership in a legal sense, they have little influence on psychological ownership. They are too hard to value, too difficult to influence, and too volatile. (See the **Sidebar**, "Stock Options and the Myth of Psychological Ownership.") Nevertheless, ownership behavior is the right idea, even if options are the wrong vehicle. A model recently developed by Professor Jon Pierce and colleagues identified three mechanisms that encourage psychological ownership in employees:[17]

- Employees must be able to exercise control over their work—to have autonomy in deciding how to accomplish the tasks they take on.
- They must have a deep understanding of their work—an opportunity to become expert.
- They must feel that in some sense they are investing themselves in their work— identifying with the importance of their jobs and taking pride in the quality of what they produce.

Manager behavior, and the personal work environments managers create, have a more profound and direct effect than any reward program does on ownership feelings and behaviors in employees. Towers Perrin's 2003 Talent Management study, a broadly focused survey of the attitudes and perspectives of 40,000 employees in companies across North America, provides evidence of this. Em-

STOCK OPTIONS AND THE MYTH OF PSYCHOLOGICAL OWNERSHIP

Stock options hold a prominent place in the cultural lore of corporate compensation. In the best of times, they represented the opportunity for uncapped wealth, the chance for everyone to get rich despite a humble place on the organizational totem pole. In the worst of times, they symbolized broken promises, like those of dot-com founders who proffered stock options in exchange for long, retina-scorching hours in front of the computer screen. Their financial and social appeal and relatively widespread use notwithstanding, the power of stock options to elicit ownership behavior has always been overstated.

Why do stock options have relatively little power to engender the feelings of work engagement that drive ownership behavior in employees? We have identified three reasons.

Options are a Black-Scholes box. *Most employees say they do not have a good understanding of how stock options work and how to determine their worth. Even managers, in their honest moments, will admit to uncertainty about stock option value. In one survey we conducted recently with a client, we asked managers to estimate the value of their stock options. Fully one-fifth of the management group did not provide any answer to the question. Many wrote comments about their "nonanswers," such as "No clue" and "The best-kept secret in the company." Those who answered gave a wide range of values, many of them far from any figure that the Black-Scholes option-pricing model or other accepted valuation method would generate.*

Options don't come with directions. *Individual employees exercise little direct influence over stock price or the company-level results that influence it. While senior executives certainly have more control over enterprise results, average option-holding employees most likely see themselves as small cogs in a big machine when it comes to driving up the earnings of the whole organization. Simply receiving option grants brings neither the insight nor the ability to identify and take actions that directly push up their value. To be sure, people appreciate it when their stock options produce wealth—just as they do when they buy winning lottery tickets. As one senior HR manager at a high-tech company put it, "Options are really just luck-based compensation."*

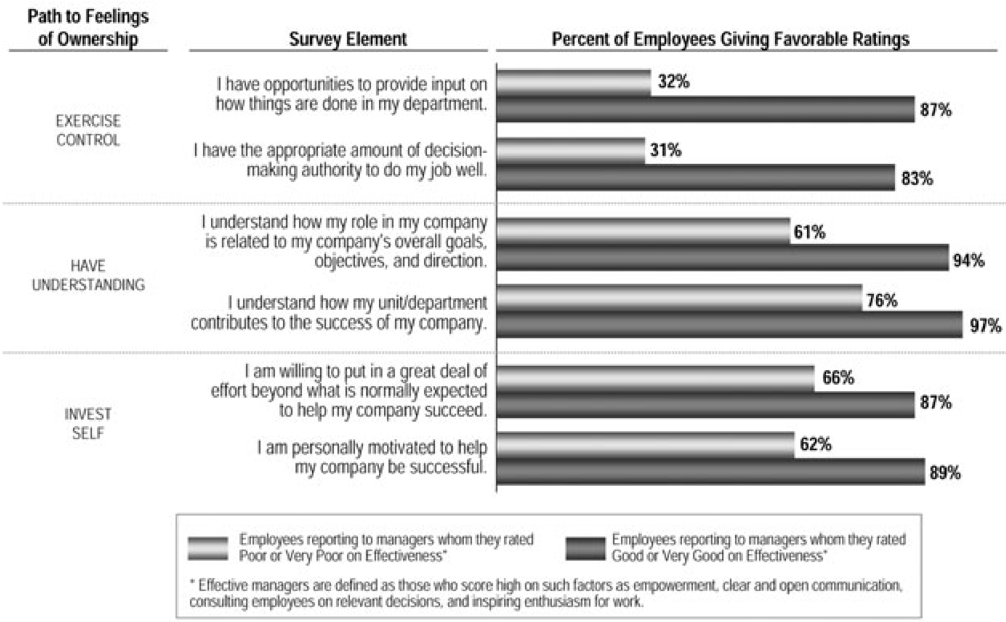
What goes up can come down. *When the equity market rises, so do the spirits of option holders and their commitment to the company. Evidence suggests that unvested grants do indeed lead people to stay with their organizations. But when the stock market heads down, do options inspire people to act like owners and stay around to bail out a sinking business? Evidently not, observes one seasoned HR executive we know. Having experienced many equity market cycles in his years in the food manufacturing, retail, financial services, and distribution industries, he has seen the incongruity of employee behavior as stock and option values rise like hot air balloons and fall like lead ones:*

> *When markets go up and options have value, people come to work happy and ready to make an effort. But I've seen people behave in some pretty discouraging ways—like spending all day with their brokers trying to protect their personal assets—when the Dow goes down. They don't act like owners then—they act like people trying to make sure they can keep up their mortgage payments.*

In other words, they stop behaving like owners, who unquestioningly invest themselves in the business, and act instead like employees whose investment of self depends on the value of the deal they get from the company. Rational behavior, yes. Ownership behavior, no.

ployees participating in this study indicated a direct relationship between overall manager effectiveness and manager performance in creating the conditions for psychological ownership—control, understanding, and investment of self. As **Exhibit 3** shows, 87 percent of the respondents who rated their managers as effective said they have opportunities to provide input on how things are done in their departments—a sense of control—compared with only 32 percent of those respondents who had said they have relatively ineffective managers. Also striking is the gap between effective and ineffective managers in their ability to provide employees with decision-making authority and an understanding of the connection between the employee's individual role and company objectives. Note in Exhibit 3 that effective managers outscore ineffective ones in addressing both emotional factors (e.g., willingness to put in extra effort, personal motivation in behalf of the company) and rational factors (e.g., understanding individual and departmental roles). These findings make a dramatic statement about the power of good managers to create the conditions within which ownership behaviors can flourish.

Exhibit 3. The Manager's Influence over Ownership Factors



The study also allowed us to compare managers' impact on ownership attitudes with the impact of rewards (base pay, incentives, stock). The results strongly reinforce the importance of managers. We found that manager effectiveness explained 30 percent of the difference between high and low ownership perception (that is, the variance in reported ownership feelings). Financial rewards added only 2 percent to the explanatory power of our model.

Among the organizations that have acted to eliminate or reduce the emphasis on stock options in their reward portfolios, Microsoft Corporation has shown itself to be particularly aware of the change implications of reward restructuring. Microsoft's compensation philosophy historically featured conservative base salaries, small incentive opportunities, generous benefits, and a broad-based stock option program. The company's options created enormous wealth during the 1990s (and with that wealth a generation of employees who came to be called "volunteers" because they did not need to work).

As the bull market fizzled and option expensing loomed on the regulatory horizon, the company, now at a more mature stage in its evolution, decided to make fundamental changes in its reward strategy. Microsoft performed a tradeoff analysis, similar to the one done by our airline client, and made two important discoveries. The first was that employees' inclination to remain with the organization would actually increase if the company were to reduce stock option availability while increasing investment in certain nonfinancial rewards and organizational programs. The latter included improving manager performance; increasing internal mobility among projects, jobs, and departments; and enhancing autonomy, responsibility, and challenge on the job. Microsoft's second discovery (really more of a confirmation) was that line managers in local work groups deliver much of what people value most about their work—elements that most directly affect their willingness to behave like owners.[18]

Yes, Microsoft retained stock—but not options—in the reward package offered to many employees. Yes, the organization still talks about using stock (again, not options) as a means to build "real ownership."[19] But what we find particularly intriguing is that this icon of the New Economy has shifted its reward emphasis away from literal ownership vehicles toward manager-delivered rewards. Managers not only helped implement Microsoft's reward changes but also now play an increasingly important part in rewards distribution. They have assumed the primary role in creating many of the elements required for true ownership behavior.

Demonstrate Individual Fairness. However sweeping reward program changes may be, employees ultimately feel the impact individually, one person at a time. Certainly, broad-scale elements of procedural fairness and supporting systems create a hospitable context for such change. Still, the essence of change—that which employees experience the most intensely—emerges in the interaction between the individual employee and his or her manager. In employees' minds, the quality of this relationship hinges on the degree of concern that the supervisor or manager demonstrates for both the rational and (especially) the emotional state of the individual employee. It is in the manager-to-employee aspect of reward change that interpersonal fairness comes into play.

In the realm of reward change, managers express interpersonal fairness in several ways:

- *Consideration of the Individual Employee's Viewpoint:* Listens to their concerns one-on-one; acts on them if possible; passes them on for a response from another source when necessary.
- *Consistent Application of Criteria:* Ensures that everyone in the local work group experiences a just and equitable (if not necessarily equal) outcome—in effect, the individual manifestation of a fair procedure through distributive fairness.
- *Justification for the Change:* Makes the case for change at the work unit level—"What it means for us as we do our day-to-day jobs."
- *Truthful Communication:* Does not varnish the truth or hold back information, however unpleasant it may be.
- *Courtesy in Delivery of the Message:* Makes a genuine expression of concern for the individual's personal circumstances.[20]

So powerful is the connection between individual and manager that managers' actions to demonstrate interpersonal fairness can actually compensate for a lack of procedural fairness. In other words, managers who consider employee concerns, speak truthfully about the reasons for reward change, and meet the other interpersonal fairness criteria can reduce resistance even when employees feel that reward changes were handled unfairly by the organization at large. A study of a group of manufacturing employees showed that interpersonal fairness is vital to the manager's ability to prevent employees from cutting back their work contributions or engaging in other forms of resistance to change. The study results indicated that when supervisors demonstrate interpersonal fairness, employees are at least somewhat willing to tolerate unfair reward distribution and unfair change procedures that would otherwise elicit retaliatory behaviors.[21]

Clearly, interpersonal fairness has powerful implications for both the rational and emotional aspects of change.

Clearly, interpersonal fairness has powerful implications for both the rational and emotional aspects of change. As potent as interpersonal fairness can be, it produces its greatest impact when it builds on a foundation of procedural fairness and effective change management processes. At our airline client, for example, managers made a point of urging HR to provide them with the information they would need to answer individual employee questions. The managers knew that they would be bombarded with questions and challenges about the reward changes. Having full information allowed them to express individual consideration, reinforce the case for change, and tell the truth—all key aspects of interpersonal fairness.

CLOSING THOUGHTS

Consider the following conversation:

> **Employee:** Hey boss, I read in the newspaper that our benefits premiums are going up. What's happening? Is the company just ripping us off again?
>
> **Manager:** Search me—I just read it on the company intranet this morning. I never know what the big wheels upstairs are thinking. I guess they're just trying to save money and prop up their stock options.

In contrast, consider this far more positive conversation:

Employee: Hey boss, I just got back from the meeting where HR told us about rising health care costs and the increase in our premiums. What do you think about it?

Manager: It hits me in the wallet too, but the numbers say that most companies are going through the same thing. At least HR told us what is happening to the health insurance expenses the company is paying, and how some other companies have it worse than we do. Anyway, the information I got says that employees care more about the bonus plan than their insurance payments, and the bonus should be pretty good this year. We should probably be looking for other ways we can save costs around here, because it doesn't sound like our benefits costs will be dropping any time soon.

Clearly, the second example comes closer to what organizations hope will happen when they implement changes to rewards. The probability of this kind of conversation depends directly on how effectively an organization has laid the necessary groundwork and integrated the manager into the reward change process.

Throughout this discussion, we have considered managers in their roles as agents of the organization and counselors of employees—and of course, they play both of these roles. But managers also experience reward changes directly. They are not just second-order functionaries—they are first-order participants as their own compensation, benefits, learning opportunities, and work environment evolve. If they feel fairly treated by the organization and by their own superiors, if their emotional and rational requirements are recognized and met, their capacity for addressing employee needs will be that much greater.

In the reward change process, managers act as agents, catalysts, brokers, counselors, friends, information sources, and trusted advisors. No one role overshadows the others, and all are critical if organizations hope to implement successful reward change without destabilizing employees and derailing organizational performance. ■

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