OCTOBER 2016

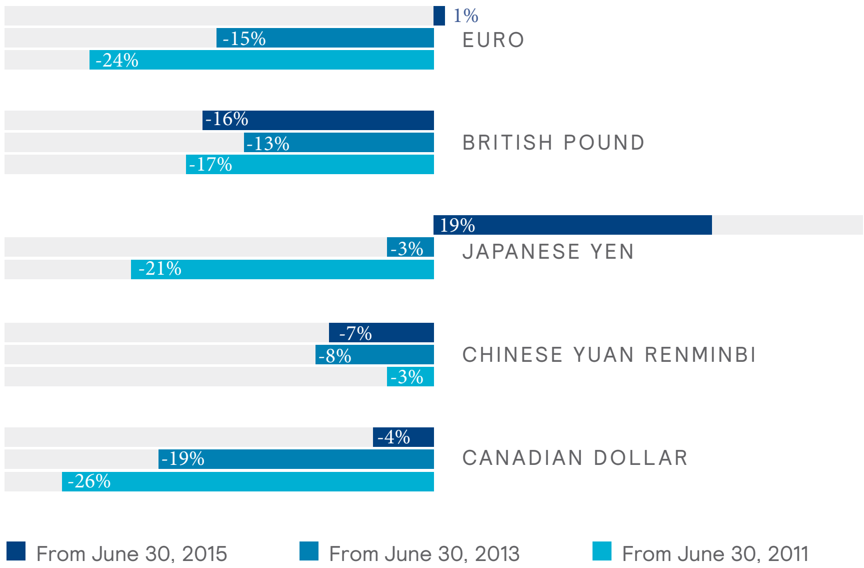
IMPACT OF CURRENCY VOLATILITY ON COMPENSATION BENCHMARKING

IN THIS ISSUE:

- To what extent has exchange-rate fluctuation affected the value of common currencies over the past five years?
- What pay benchmarking challenges arise because of this fluctuation?
- What tactics can mitigate the challenges?

Among the economic headwinds confronting compensation professionals at multinational corporations, one of the most consequential in recent years is depreciation (or appreciation) of the home currency vis-à-vis other currencies that may be used for compensation benchmarking. Exhibit 1 illustrates levels of fluctuation for five currencies relative to the US dollar over a five-year period, from June 30, 2011, to June 30, 2016.

EXHIBIT 1: 1-, 3- AND 5-YEAR CHANGE IN CURRENCY VALUE — ENDING JUNE 30, 2016



See Appendix for currency translation rates.

> “These rates have important implications for companies that handle their payroll in multiple currencies.”

The depreciation is particularly severe for Canada and the eurozone, where the value of local currency has fallen 26% and 24%, respectively, over the five years. In the most recent year alone, the British pound swooned 16% against the US dollar, whereas the Japanese yen strengthened considerably.

These rates have important implications for companies that handle their payroll in multiple currencies. In Canada, where cross-border executives are sometimes paid in US dollars on a basis that is nominally equivalent to Canadian dollars, fluctuations in the exchange rate by themselves may be a source of unearned windfall (or unjustified shortfall). In 2016, all else being unchanged, the currency differential alone would amount to a 4% pay raise for Canadian employees paid in US dollars.

Companies in Ireland typically do not pay Irish (euro-based) and British (pound-based) employees on a notionally equivalent basis, but they still deal with challenges affecting compensation arrangements across a common border, as do companies in mainland China paying in the Chinese yuan and in Hong Kong paying in the Hong Kong dollar. Companies that rely on compensation surveys denominated in foreign currencies encounter translation complexities even if they do not have international operations.

This issue of *Perspectives* explores the problems that arise from currency volatility with respect to pay benchmarking — specifically in connection with proxy comparisons, although challenges may also arise from using compensation surveys denominated in a foreign currency.

WHAT CURRENCY IS THE “HOME CURRENCY”?

Before addressing issues of multiple currencies, it is important to identify the benchmark currency. This is not necessarily the currency in which the company is domiciled, or the currency in which it presents its financial results (although typically it is). The benchmarking currency should be the currency of the primary environment from which the company sources and pays its executive talent. For example, oil companies in Nigeria or Venezuela often use the US dollar as its benchmark — thus, compensation paid in Nigerian Naira or Venezuelan Bolivar may be sources of currency volatility relative to the “home currency.”

IMPACT OF EXCHANGE MOVEMENTS ON BENCHMARKING RESULTS

To illustrate the impact of exchange movements on benchmarking results, let us assume there are no year-over-year changes to pay levels at your company vis-à-vis your benchmarking comparators. However, if the home currency appreciates over the currency of your international peers, then your competitive pay position will appear to have increased. Your company's compensation committee may decide not to increase pay, given the additional "heft" provided by the home currency's strength. Conversely, the competitive pay positioning of your international competitors, who examine the results of the benchmarking study for their own purposes, experiences exactly the opposite effect: The value of their compensation on the "world market" declines along with the currency. Their compensation committees may decide to increase pay levels, to guard against potential recruitment by companies with stronger currencies. In either case, the compensation committee should consider carefully whether to adjust compensation in response to currency fluctuations, since economic winds could change rapidly from one year to the next, and a decision taken too hastily could backfire in the following year.

> "Using spot rates when benchmarking compensation is quite possibly the worst way to manage the impact of inevitable currency volatility."

WHAT'S WRONG WITH USING THE SPOT RATE?

Spot rates — the exchange rates posted by the US Treasury and its foreign equivalents — provide reliable, near-instant bases for converting currencies. But changing compensation concurrently with currency fluctuation poses serious problems:

- **Administrative complexity:** Spot rates change daily; however, compensation adjustments cannot occur daily. To prevent the process from becoming excessively burdensome, compensation adjustments can be made only occasionally. The longer the gaps between adjustments, the larger those adjustments might need to be.
- **Employee distraction:** The compensation program's chief objective is to align the employee's motivation with the company's success. Making changes to compensation based on currency swings introduces an extraneous element beyond the company's (or employees') ability to control.

Using spot rates when benchmarking compensation is quite possibly the worst way to manage the impact of inevitable currency volatility. Because they are constantly in flux, their validity is fleeting and susceptible to macroeconomic disturbances that do not necessarily impact the labor market. Using spot rates exacerbates the challenge of competitive benchmarking because it maximizes the extent to which the value is left to chance.

TACTICS TO MITIGATE THE IMPACT OF CURRENCY VOLATILITY

We list five methodologies companies could adopt in analyzing pay competitiveness that is impacted by unstable currency movements:

1) *Avoid currency issues altogether.*

    a) Restrict peer group to companies in the home currency.

    b) Instead of adjusting for currency fluctuations, compare the cost of living in each region and base cross-border compensation decisions on purchase power parity.

2) *Adjust currency at something other than the prevailing spot rate.*

    a) Use 12-month (or longer) trailing average currency rates.

    b) Use a constant or fixed rate.

    c) Readjust when currency fluctuation exceeds a specified threshold.

1) Avoid currency issues.

    a) *Consider whether to use an international peer group at all.*

Sometimes it is unnecessary to create an international comparator group. For example, an executive may not be internationally mobile or there might be sufficient supply of executive talent within the home currency market, in which case the impact of fluctuating exchange rates on market values for executive talent does not arise. A purely US or Chinese manufacturing company may hire its executives only from the domestic market, and there is little likelihood that executive talent will be poached by international competitors.

However, there are many circumstances in which companies have to recruit from the international market or where their executive talent is internationally mobile. For example, many companies in some eurozone countries, as well as in Switzerland, Hong Kong, Singapore and Canada, are forced by the limitations of their home-currency talent market to create international comparator groups. This also applies to survey use, when the home-currency market does not support adequate data for robust position matches in local salary surveys.

    b) *Use a Purchase Power Parity rate to determine relative* value.

The objective of purchase power parity is to ensure that executives of the same rank enjoy the same standard of living, regardless of location. Accordingly, this approach takes into consideration the cost of maintaining a lifestyle consistent with the executives' stature, net of taxes. Appropriate budget allocations for food, transportation, housing, healthcare and other necessities are determined based on the local cost of these items. Local costs depend primarily on regional economic conditions, the availability of goods and services and other considerations. In 2016, for example, Mercer's *International Living*

Wage Report showed that inflation in Canada raised the cost of goods and services 1.6%. Inflation in the US was 1% over the same period, so the relative decrease in the purchasing power of Canada-based employees who are paid in US dollars was partially offset by the gain they experienced from the 4% erosion in the Canadian currency's value.

2) Adjust currency (at something other than the prevailing spot rate).

a) Use a 12-month (or longer) trailing average.

Exhibit 2 illustrates that using average exchange rates produces more stable results than using spot rates. We assume a peer group of six companies with two companies drawn from Europe, Asia and North America, respectively. We have assumed the same starting salary on June 30, 2015, of US$1,000. The greater stability in the resultant US dollar pay levels is revealed in a spread between the highest and the lowest pay of US$106 (US$1,047–US$940) when using the average rate, which is much smaller than the spread of US$347 (US$1,189–US$843) when using the spot rate.

Note that the smoothing also affects the relative positioning among the companies, thereby potentially affecting the compensation committee's decision as to whether salaries should be increased or kept at their current rate (it being very unlikely that salaries would be reduced solely on the basis of relative currency value). If the spot rate were used, British Co. might increase the incumbent by as much as US$157 to bring it in alignment with the third-ranking peer (US Co.). By smoothing the rates on a 12-month average basis, the gap between British Co. and the third-ranking peer (Euro Co.) is considerably less extreme: US$52, the difference between Euro Co.'s US$995 and British Co.'s US$943.

EXHIBIT 2: SPOT RATE VS. 1-YEAR AVERAGE FLUCTUATION

Comparators	2015 USD salary	2015 USD domestic currency salary	2016 USD currency salary using spot rate	Rank spot rate	2016 USD currency salary using 12-month average rate	Rank 12-month average
Euro Co.	$1,000	897	$993	2	$995	3
British Co.	$1,000	636	$843	6	$943	5
Japanese Co.	$1,000	122,160	$1,189	1	$1,047	1
Chinese Co.	$1,000	6,199	$932	5	$962	4
Canadian Co.	$1,000	1,248	$960	4	$940	6
US Co.	$1,000	1,000	$1,000	3	$1,000	2

See Appendix for the relevant spot and 12-month average rates.

b) Use a constant or fixed currency rate.

Another approach is to translate pay levels on a constant currency basis, either applying the prior year's exchange rate to the current-year salary (historical rate method) or applying the current year's rate to the prior-year salary (current rate method). The constant currency method excludes the impact of currency fluctuation and isolates changes in pay for each company year-on-year. Its drawback is that it generates a fictitious, fabricated number.

In Exhibit 3, under both the historical and current rate methods, it is easy to see that US Co. alone among the peers raised pay rates between 2015 and 2016.

EXHIBIT 3: CONSTANT CURRENCY METHOD COMPARISONS

<table>
<tr><th rowspan="2">Comparators</th><th rowspan="2">2015 domestic currency salary</th><th rowspan="2">2016 domestic currency salary</th><th colspan="3">Historical rate method (spot) (using 2015 FX rates for for both)</th><th colspan="3">Current rate method (spot) (using 2016 FX rates for both)</th></tr>
<tr><th>2015 USD salary</th><th>2016 USD salary</th><th>Change</th><th>2015 USD salary</th><th>2016 USD salary</th><th>Change</th></tr>
<tr><td>Euro Co.</td><td colspan="2">897</td><td colspan="2">$1,000</td><td>-</td><td colspan="2">$993</td><td>-</td></tr>
<tr><td>British Co.</td><td colspan="2">636</td><td colspan="2">$1,000</td><td>-</td><td colspan="2">$843</td><td>-</td></tr>
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<tr><td>Canadian Co.</td><td colspan="2">1,248</td><td colspan="2">$1,000</td><td>-</td><td colspan="2">$960</td><td>-</td></tr>
<tr><td>US Co.</td><td>1,000</td><td>1,050</td><td>$1,050</td><td>$1,050</td><td>+5%</td><td>$1,000</td><td>$1,050</td><td>+5%</td></tr>
</table>

Comparing between companies can give very different answers depending on whether the historical rate or the current rate method is used. Under the historical rate method, US Co. clearly ranks the highest among its peers. However, under the current rate method, Japanese Co. is ranked first, whereas US Co. is ranked only the second highest. An argument can be made that it is better to follow the current rate method by retranslating last year's pay levels by the current year's exchange rate and then comparing against this year's actual pay levels, as in this way the focus remains on the actual figures for the current year. Any investment in international executive talent would also have to be made using the current exchange rates.

c) Readjust when currency fluctuation exceeds a specified threshold.

To avoid micro-changes that demand careful administration but may have little impact on actual pay positioning, companies may choose to readjust for currency variances only in cases where those variances are substantial. For example, a change of +/-15% from the home currency could trigger reconsideration of pay, with the amount adjusted using a spot, trailing average or fixed exchange rate.

WHICH APPROACH IS BEST?

Making no use of international peers at all is infeasible for companies that need to recruit from an international market. For the vast majority of others, we recommend that the compensation committee identify a single approach that provides the optimal solution in most circumstances and make exceptions on a carefully defined basis. The table below shows the advantages and disadvantages of four approaches.

	Advantages	Disadvantages
Purchasing power parity rate	• Ensures that changes in the benchmark are a result of changes in underlying economic conditions rather than simple changes in exchange rates • Provides relative stability of benchmarked pay levels and positioning against benchmarks year-on-year, undistorted by currency • Equalizes purchasing power of income for executives across different home territories	• Unusual • Use of unfamiliar exchange rates may appear complex requiring significant communication • Rates can vary significantly from spot foreign exchange rates • During recruitment, potential employees compare packages at spot rates
Spot rate	• Transparent to participant • Reflects market's views of relative worth of currencies • When hiring, individuals tend to make comparisons on a spot basis	• Highly volatile compensation levels in benchmark currency
Trailing averages	• Common approach (particularly 12-month trailing average) • Mitigates short-term volatility	• Volatility in the compensation benchmark currency reduced but not eliminated • Artificial exchange rate used • Not very transparent to participants
Constant (fixed) rate	• Focuses on differences due to changes in compensation rather than currency fluctuation	• Not transparent to participant

IMPORTANCE OF COMMUNICATION AND TRANSPARENCY

The purpose of compensation benchmarking is to help compensation committees make decisions about investments in executive talent. Given the unpredictability of currency movements, the best strategy is to make the impact transparent to proxy readers by providing supplementary information, such as showing competitive pay positioning using 12-month trailing average or constant exchange rates and discussing in the compensation report the role currency volatility played — if any — in pay decisions.

For their part, committee members should seek to understand how pay changes among international peers independent of the currency implications. They should take a long-term view to managing currency fluctuations and not make rash decisions that they may come to regret later, when currency movements may have reversed.

APPENDIX

TRANSLATION RATES (IN US$)

Currency	June 30, 2011	June 30, 2013	June 30, 2015		June 30, 2016	
	Spot	Spot	Spot	12mavg	Spot	12mavg
Euro	$1.451931	$1.300965	$1.115269	$1.19551	$1.107663	$1.10921
British pound	$1.606408	$1.521000	$1.572510	$1.57599	$1.325325	$1.48322
Japanese yen	$0.012398	$0.010082	$0.008186	$0.00872	$0.009736	$0.00857
Chinese yuan renminbi	$0.154715	$0.162941	$0.161321	$0.16160	$0.150404	$0.15522
Canadian dollar	$1.037017	$0.950616	$0.801585	$0.85264	$0.769722	$0.75376

ABOUT THE AUTHORS

HANS KOTHUIS
Partner, Executive Rewards Practice Leader (AMEA), Hong Kong
hans.kothuis@mercer.com

TED JARVIS
Principal, Executive Rewards, Washington; Global Director, Executive Rewards Data, Research and Publications
ted.jarvis@mercer.com

STUART HARRISON
Senior Associate, Executive Rewards, London
stuart.harrison@mercer.com

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CONTACT US

GREGG PASSIN (North America)
gregg.passin@mercer.com

MARK HOBLE (Europe)
mark.hoble@mercer.com

HANS KOTHUIS (AMEA)
hans.kothuis@mercer.com

DANIEL YIN (Australia)
daniel.yin@mercer.com

MARTIN IBAÑEZ-FROCHAM (Latin America)
martin.ibanez-frocham@mercer.com