LOCALIZING EXPATRIATES: PITFALLS, PROBLEMS & POLICY PLANNING

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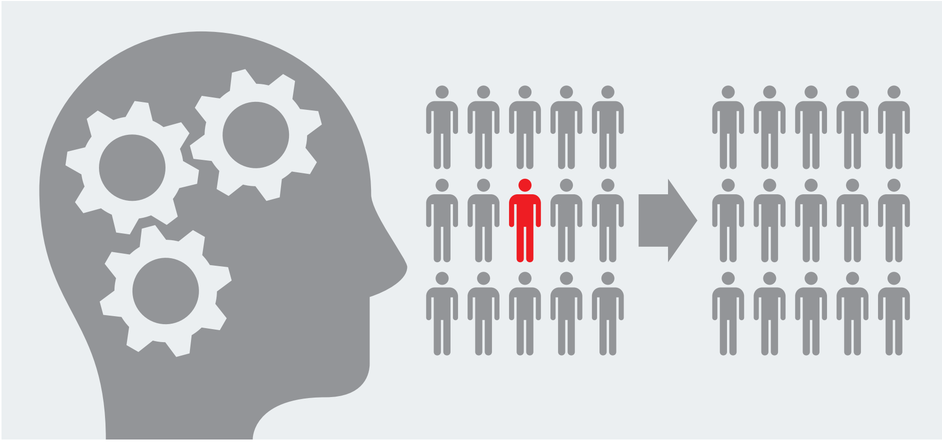
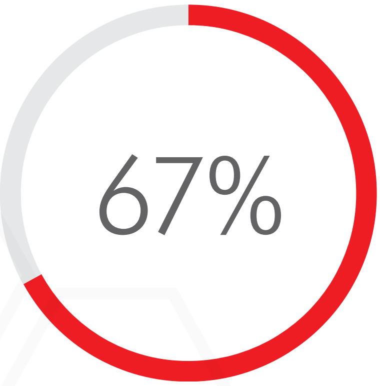


Percentage of mobility managers report "compensation packages" as the biggest area where international assignee expectations are not met



Overview

As the fierce competition for foreign talent increases, compensating expatriates is undoubtedly becoming more and more complex, being complicated by fluctuating exchange rates, inflation, challenging locations in emerging markets, variable income tax rates, and a range of new compensation practices. It is no surprise then that, while expatriate compensation is often regarded as a key component of effective international assignment management, it has also long been a source of frustration for many companies. A survey by Ernst & Young, for example, found that 67 percent of mobility managers report "compensation packages" as the biggest area where international assignee expectations are not met. One challenge is how to overcome compensation disparity between expatriates and local employees that work directly with them. Another is how to mitigate the opportunity costs associated with reduced compensation approaches such as "local-plus" and "localization", both of which represent cost effective alternatives to the balance-sheet approach – but often with unforeseen consequences. In this white paper, we take a closer look at one of these new compensation approaches – *localization* – and examine: (1) what it is; (2) why, when, and where it is used: and, (3) how some of the problems it creates for companies can be overcome.

What is localization?

Localization is a compensation approach in which assignees are paid according to the salary levels, structure, and administration guidelines of the host location where they are being sent to, or are already living and working. Localization involves the removal or absence of an assignee's "expatriate" status from a policy standpoint, including benefits and allowances. In practical terms, it means that ties back to the home country from where an assignee has come from, or from where they may have originally been remunerated, are severed and the assignee becomes a "local" in the host-country. It almost always involves replacing a salary package (e.g. base salary, incentives, allowances, perquisites, social security, and retirement plans) with compensation comparable to that offered to locally hired employees.

Localization occurs in one of two ways. In delayed localization, an expatriate commences an international assignment on a balance-sheet or local-plus approach and, after a period of between three to five years, then transitions to local terms and conditions (i.e. is "localized") directed by either the employer or employee. Some assignees relocate, for example, with full knowledge that localization will occur after two years in the host-country as pre-determined in their contract, whereas other assignees may not be localized until completion of the initial, or subsequent extension(s) of, the assignment which may be five to seven, or even ten, years after it first began. Delayed localization may also occur when expatriates do not wish to repatriate or re-assign as directed by their company, electing instead to remain in the host location on local terms and conditions.

Transitioning to localization involves phasing out special expatriate benefits (such as transportation, housing, and the costs of dependents' education) over a transition or "wind-back" period during which remuneration is reduced incrementally over a one to three year period (e.g., 30% phased out in Y1, 30% in Y2, and 40% in Y3). Within this timeframe, it is common for localized assignees to resign from his/her home country office and to be formally hired by the host country office of the same company for accounting purposes.

Immediate localization, on the other hand, takes place at the onset of an assignment, typically in the form of a "permanent" or "one-way" transfer. Employees know from the outset that they will be localized which removes the company's obligation to repatriate or re-assign them elsewhere.

The distinction between delayed and immediate localization is highly important because how and when local status is enacted will impact on assignees differently, particularly for those that did not initially undertake an assignment with localization in mind. This can create unintended problems for companies, for example, when localized employees incur the same adjustment and social challenges as "expatriates" (because they are for all intents and purposes still "foreigners") but must cope without company support (e.g., cross-cultural and language support, family support, and so on). This may explain why many companies often deal with localization on a case-by-case basis. Importantly, there will be cases where neither the company nor the assignee intends for delayed localization to occur but that it arises as an assignment progresses, taking into account changes in company strategy or expatriates' life circumstances as well as other unexpected events (e.g. economic downturns).

Why is localization used?

Companies typically use localization as an operational cost cutting measure in order to reduce compensation and other costs. For companies serious about improving their expatriate return on investment, localization is often used as a proxy retrenchment tool for expatriates whose performance in the host-location no longer warrants the expense that the balance sheet approach demands. Bearing in mind that global mobility incurs considerable costs that are prohibitive for many organizations, localization offers an alternative, less expensive solution to global staffing, buoyed by the availability of more and more employees willing to accept localized terms and conditions in exchange for valuable international experience.

The decision to engage in localization practices can also be of high strategic value to companies in terms of maximizing both talent management and cost containment. For example, a recent survey found that a common reason for localizing assignees is that an employee has a skill set that is needed long term in the assignment location. Localization also helps to minimize perceived inequities between expatriates working with local staff, many of whom perform similar roles but whose salary and benefits often vary significantly.

Additionally, localization can help to support a company's strategy of local responsiveness in processes, routines and practices, particularly when there is a need to demonstrate long-term commitment to a particular host country or region (for example, in Asia there is a strong tendency towards employing Asian expatriates or "returnees" - many of whom are not offered expatriate packages). The upside of localization therefore is that while the traditional reasons for needing expatriates (e.g. knowledge and skills transfer, global control and culture, career development) remain valid, more localized assignees now have a level of managerial talent that they can often compete for jobs with "full package" expatriates. This reduces global mobility costs for companies, widens talent pool and sourcing opportunities, and provides employees with more job opportunities on the international labor market.

Localization can also be requested by assignees that express a desire to remain in the host location, a trend that we see increasingly in Asia. Recent research suggests that employees actually seek out seek out localization as part of permanent transfer arrangements as a step towards fulfilling their own career development, even though doing so often increases their marketability to other employers and can cause attrition problems for their company.

Case #1:

'Forever Expats' at FoodCo

Elaine is a global mobility manager at a large UK-based retailer, FoodCo. With an expatriate population of around 450 assignees, FoodCo has been using localization approaches for some time, mainly to reduce the problem of 'forever expats' whose assignments seem to go on and on without ever seeming to end. Although the majority of FoodCo's assignees are outbound UK nationals, of which few localize in the host-country due to UK pension challenges, those that agree to localize do so because they see their long-term career as being in that particular host-country.

Localization has also been quite successful when hiring foreigners already based abroad, for example, when a UK national is based in Hong Kong and hired there on a local contract. It is also used to 'inpatriate' foreigners into the UK headquarters. "Moving people into the UK on local terms is easier," explains Elaine, "especially when they come from Asia."

Although localization has been successful among certain types of assignees at FoodCo, it isn't necessarily a formal policy. "It's more like a guide," says Elaine, "that we use to help the business decide what to do. We try to limit the exceptions to the one off payments, and not the ongoing compensation."

While FoodCo uses a mix of options to localize, the most common approach is to phase it in over a period of two years, with full allowances in Y1, half in Y2 and nothing in Y3. There are other options, too, depending on the situation. For example, the local hire of a foreign national (that has been an expatriate at some point) may still receive some benefits (e.g. school fees) even though they are already on a local hire contract. Alternatively, the local hire of a foreign national who has lived in the country for a number of years might be offered a lighter approach, for example, medical or immigration support.

Does localization deliver to FoodCo the intended benefits? "I'm not sure we use it properly," Elaine explains. "Although we haven't really analyzed it, I wouldn't say it's successful."

"I think there is a suspicion that we will lose people that localize. Plus, the reality is that people never really fully localize anyway and they do maintain ties back to the home country. For example, I've seen us localize an expatriate, only for them to go on an expatriate assignment from their new home country!"

Is it necessary to have a localization policy?

Because there has been a marked increase in localization practices, particularly in established markets in Asia such as Singapore, Kuala Lumpur, and Hong Kong, more companies now have a formal localization policy in place, especially those with large expatriate populations. This means either a single policy to cover all locations or multiple policies tailored for specific locations. The remainder of companies handle localization informally with no policy in place. It is worth noting however that of the companies with a policy in place, the majority still tend to enforce their policy on a case-by-case basis, adopting some degree of negotiation between policy and the particular needs of the assignee.

Does localization work in all locations?

Some locations are too challenging to introduce a localization approach. Mainland China, for example, has a combination of high taxes and low salaries which would impose too much of a financial liability on assignees from certain home-countries such as Singapore, Hong Kong, USA, and UK. It is also not possible for foreigners to utilize local housing and medical schemes in China, so while the idea of a localization approach seems attractive, careful consideration must be given to weighing up the cost versus benefits to assignees in terms of the home/host country mix. The willingness of employees to accept localization from Europe, for example, to low tax countries like Singapore or Hong Kong could, however, be higher. Dubai, with zero tax, is also highly attractive for localization.

Is localization a magic bullet?

While localization offers companies many short-term cost savings, the question remains whether it enables organizations to achieve their long-term goals regarding talent management and knowledge sharing. Surprisingly, there is very little research on the implications arising from localization despite the prevalence with which it is being utilized. What we do know, in practice, is that localization creates many problems not just for companies, but also for assignees:

1. There are likely to be different implications for assignees localized from the outset of an assignment or within a two-year timeframe but who knew from the outset that localization would occur, versus those assignees who do not initially undertake an international assignment with localization in mind. In the latter case, assignees will no longer have access to allowances and incentives, ultimately resulting in unplanned lost income and financial disadvantages. Unplanned localization can also impact on assignees' psychological contract, leading to resentment, thoughts of leaving, and reduced engagement.
2. While localized employees are viewed and treated differently by companies in terms of policy, status, and compensation, they are still expatriates and as such likely to face the same adjustment challenges as balance-sheet expatriates but without the same level of support. Their adjustment challenges are the same because, like traditional expatriates, localized assignees are not citizens of the host-country.
3. Localization often creates an "organizational hierarchy" whereby assignees are treated differently in career management and retention terms on the basis of those considered "expatriates" versus those considered "local." This can then result in reduced morale and impact on the willingness-to-go factor among potential assignee candidates.
4. Assignees that perceive they are not sufficiently supported or 'valued' by a company in comparison to other types of expatriates are at risk of looking for job opportunities with competitors who may be prepared to offer even a fractional increase in salary (see Case #2).

Is localization the magic bullet many companies perceive it to be? The latest research suggests that the use of 'cheaper' assignments that seem appealing to many companies can also lead to unintended outcomes in terms of unforeseen opportunity costs (such as the loss of critical talent) arising from "shortsighted decisions". What, then, can companies do to mitigate the risks that localization presents?

Case #2:

'Salary Creep" at BankCo

Charles has recently retired as a global mobility professional of over 30 years experience with a number of major multinationals, including his last role at a European-based financial services firm based in Hong Kong. With an assignee population of 800 expatriates inbound to Asia Pacific annually, and 110 outbound to the rest of the world, Charles is skeptical that localization is the "holy grail" many companies expect it could be.

"It's a short term knee-jerk reaction to a need to reduce cost," explains Charles, "especially during economic downturns like we had in the late 1990s and during the recent global financial crisis."

"Insofar as it achieves cost-reduction with a limited number of people, the problem it causes is "salary creep" within the general population," he says. "The individual who is localized gets a modest or no increase in salary, and becomes demotivated … there is high risk of losing that talent when the economy picks up … so his base salary then becomes inflated over time to keep him as well as other members of the team onboard."

There can also be resentment among local staff where differentiation among the various types of 'employees' gets out of control, leading to salaries everywhere getting increased to 'keep people happy'.

Another problem Charles sees with localization is that it breaks the link between global mobility and talent management, where the ties between corporate and the individual completely break down. "When you break the link, the person has their own worth in their particular geography, and they become free agents. The problem is that jumping ship to competitors is not taking years, but is within months. The process of localization completely destroys the talent management model."

In Charles' eyes, localization is a win for today but the long-term impact is detrimental to the organization. He contends that companies are enormously short sighted by not taking into account the political and economic reality of global mobility and the personal, economic, and career drivers of talent management, because there is no holistic view. "Most employees will sell their worth for as much as they possibly can –there's no loyalty when you localize."

Does localization ever work? Charles thinks it works best only for certain destinations and for foreign local hires, because they are already in the locations where talent is needed and many are used to being hired on local terms. Otherwise, he argues, localization is complete nonsense.

"Most of the time localization is driven by corporate HQ wanting to shift headcount out of corporate Head Office to the regions, but the local offices do not want to accept expensive people on their headcount. They will only accept them on local terms, but these people always come with home country long-term benefits as well, so it ends up getting disguised as something other than 'headcount'. The recharge from HQ to the local office is often not really known, or recognized, being hidden somewhere or bundled into something else and not truly revealed. That is not localization!"

Policy "best practice" for successful localization

When developing a localization policy, consider the following:

- Enter into localization discussions early (no surprises), and put all agreed items in writing via an assignment letter, letter of understanding, policy document, or formal contract.
- Provide solutions to address assignee's concerns about retirement plans and health care coverage, typically two of the biggest challenges. One way to handle social security, health and life insurance, and employer-provided pension plans is to enrol the employee in the local plan immediately.
- As far as is possible, establish a consistent approach for local compensation packages, particularly if your company intends to localize more assignees in a particular location. There are typically two options: (1) transfer salary and bonus to local terms immediately, eliminate all benefits, and provide a lump-sum payment to help with the transition; or (2) phase in the new salary and bonus over a two- or three-year period.
- Be mindful to consider requests to continue the payment of international school fees for children. This is often a highly emotional issue for assignees as the local school system may not be a viable alternative due to language barriers or curriculum challenges.

One of the biggest challenges companies face is how to convince expatriates to localize. When an expatriate refuses the offer of localization, consider the following options:

- Repatriation
- Re-assignment to another location
- Negotiate additional benefits in the localization package (e.g., a longer phase-in time, school fees, subsidized housing)
- Enforce localization and terminate the assignee's employment

In addition to formal policy elements, it is important to recognize that localization requires careful management aside from only financial considerations, in terms of how localized assignees can adjust to their new status and are integrated among a local workforce permanently. Consider the following:

- Localization implies a one-way transfer with little or no opportunity for repatriation. In practical terms, it is important to facilitate realistic expectations among assignees as to the potential career paths likely to arise from their now- permanent stay in the host-country.
- Mentoring specifically related to acculturation into the host culture seems essential, on the basis that these assignees are not 'true locals' despite their status as 'localized assignees'.
- There is a need to recognize the vital role to be played by local employees in helping localized assignees to adjust, as well as to alleviate the perceived negative benefits associated with localizing expatriate employees to the detriment of developing local staff.

No policy option or solution is absolute because every company is different. Listening to assignees concerns about localization and considering the broader picture are essential. It's important to remember that the loss of even one strategically important assignee can be devastating to a company, so careful consideration about the opportunity costs of localization (e.g., loss of talent) is critical.

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