

## Key Considerations for Incentive Design

by Margaret N. Fleming

Incentive compensation is widely promoted as supporting “pay-for-performance” and being necessary “to attract, motivate and retain” high performing individuals. However, it is also seen as having played an important, and negative, role in the 2008 financial crisis. In redesigning incentive plans, we must consider:

- What research tells us about the relationship between pay and performance, and
- The “performance environment”.

The research on pay-for-performance *as it is actually implemented* raises some important concerns. Studies among general industry companies dispute whether top executive pay in fact reflects company performance, and in one study of 271 CEOs no significant statistical relationship was found between total CEO pay and total shareholder return.<sup>1</sup> Some Boards have taken this concern to heart and adjusted CEO pay; future studies will no doubt examine whether or not the pay-for-performance relationship is changing for CEOs.

Another case, researched by a Harvard professor, examined the effectiveness of ‘team bonuses’ at Hewlett Packard in the 1990’s and found that, despite favorable conditions, the overall impact was negative and the program was discontinued.<sup>2</sup> Although the case is not recent, and concerns teams, it is thought-provoking, and challenges traditional views about the relationships between incentives, motivation, pay and performance.

Further, research by PwC surveyed in meaningful detail the views of executives in the US and globally towards incentive compensation. Among other findings about pay in this interesting work was: “it’s clear from the [survey] results that risk aversion increases with the amount at stake”.<sup>3</sup> That is, as the size of a potential incentive award increases, executives become more risk averse, and would choose a lower award with certainty, instead.

The PwC study also found that “Complex [incentive] plans are a motivation killer. The idea that we can manage by incentives has led to evermore complex metrics frameworks and formulae. These have many consequences, most of them unintended. But a key one is the further reduction in value they cause in the eye of the executive.”<sup>4</sup>

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<sup>1</sup>Jessica Silver-Greenberg and Alexis Leondis, “CBS Overpaid Moonves \$28 Million, Says Study of CEO Pay,” Bloomberg.com, [www.bloomberg.com/news/print/2010-05-06/cbs-overpaid-leslie-moonves-28-million-in-study-of-executive-compensation.html](http://www.bloomberg.com/news/print/2010-05-06/cbs-overpaid-leslie-moonves-28-million-in-study-of-executive-compensation.html) (accessed February 15, 2013). Examining “pay-for-performance” requires interpreting proxy data, defining “performance” and modeling assumptions. See also Michael K. Ozanian and Elizabeth MacDonald, “Paychecks on Steroids,” Forbes.com, [www.forbes.com/free\\_forbes/2005/0509/134.html](http://www.forbes.com/free_forbes/2005/0509/134.html) (accessed February 15, 2013).

<sup>2</sup>Martha Lagace, “Pay for Performance Doesn’t Always Pay Off,” *Working Knowledge* (April 14, 2003), Harvard Business School, <http://hbswk.hbs.edu/cgi-bin/print/3424.html>.

<sup>3</sup>PwC, “Making Executive Pay Work: The Psychology of Incentives,” 14, <http://www.pwc.com/us/en/hr-management/publications/executive-pay-incentives.jhtml>.

<sup>4</sup>PwC, 28.

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Finally, the PwC study notes: “the *recognition* provided by participation in LTIPs [long-term incentive plans] seems to be more important to motivation than the financial incentive.”<sup>5</sup> [my italics]

Given the public attention to executive compensation levels and company performance, the strategy for some companies has been to shift the pay mix toward greater ‘risk pay’ – but, does this make sense?

Incentive compensation, like strategic planning, must be designed to fit the individual company, and not what everyone else does. Incentives cannot be expected to overcome weaknesses in strategy, organization, culture, or resources/processes; nor to substitute for management accountability. These elements comprise the *performance environment*. This understanding is critical.

In 2008, we saw many weaknesses in company performance environments, including:

- **Business planning/goal setting:** Short-term thinking; plans lacking ERM integration; management/Board not understanding complex products or diversification risk; assumptions and modeling not carefully examined; failure to evaluate systemic risks;
- **Product design/modeling:** Products designed to obscure risk; price wars affecting assumptions and profitability;
- **Management:** inadequate Due Diligence on ratings; ignored warning signs of fraud/unauthorized activities; obscured balance sheet risks via use of derivatives; postponed/reduced certain expenses to increase current profits; increased reported volume and profit by underpricing or increasing risks assumed; invested in higher yield assets that increase portfolio performance but risk significant capital losses in the future; silenced voices that questioned the wisdom of the ‘herd’;
- **Organization/culture:** Some Board/managers lacking skills for their roles; the risk management function not elevated in many organizations; diversification & risk correlations not well understood; production emphasis not balanced with quality (risk); transparency lacking; various organizational barriers to communication were cited by Tim Cardinal and Jin Li in their Part 2 essay *Victory at All Costs*<sup>6</sup>;
- **Systems and processes:** underdeveloped risk modeling and application; guidelines for underwriting, accounting and investments vulnerable to modification under business pressures.

What could incentive compensation accomplish, given those issues? What performance would be reflected in company results? No company had all of those weaknesses, but many companies had multiple issues in these areas.

Much work has been done by companies to address these issues. However, to improve the incentive plans, an accurate current picture is important. Here’s where I’d start:

1. *What is the current performance environment?* What are the overall priorities and the key issues? How are they being addressed?

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<sup>5</sup> PwC, 29.

<sup>6</sup>Tim Cardinal and Jin Li, “Victory at All Costs,” *Risk Management Call for Essays Part 2: Systemic Risk, Financial Reform, and Moving Forward from the Financial Crisis*, (Society of Actuaries: Jan.2011), 40-43, <http://www.soa.org/library/essays/fin-crisis-essay-2011-toc.aspx>

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- *How robust is the strategic planning and goal-setting process?* For example, what is the effect of current capital markets conditions? Of e-commerce and mobile technology? How are individual goals set? Are companies confident in long-range plans? Does it benefit the business to cement goals by linking them to pay? Will overachievement or underachievement reflect performance fairly?
  - *How is performance measured? Are systems in place to support it?* How will regulatory changes impact performance measurement? What is the quality/transparency of communication? There is strong feeling against short-term emphasis and in favor of longer-term measures. Yet, research suggests the benefit of long-term incentives is less about motivating performance and more about recognition. Sustaining motivation over the long term requires cultural and communication emphasis.
  - *What is the culture, including the current reward system?* What are the characteristics/values of the organization? In what ways besides pay do we attract, motivate, retain and reward? How do we evaluate individual performance?
2. *There is a case to be made for less leverage in incentives, not more.* In environments where significant risk challenges are present, the incentive compensation opportunity should be less, not more. Further, companies with performance environment issues may hinder their ability to address those issues *and/or* may enhance internal conflict, by having significant risk pay on the table. Also, to the extent that incentive participants feel results are not under their control, it adds little value and may actually be demotivating for some.

Incentive compensation is one element of a reward system, and there are additional ways to reflect pay-for-performance. Executives and managers are expected to give (and do give) their best efforts as a condition of employment. They are paid salaries which in themselves give management the right to establish priorities, provide performance feedback and otherwise exert management control. Non-cash rewards such as promotions, key projects, leadership roles, increased visibility, cross-training, career development, etc. are powerful rewards that can be motivational and effective in attracting and retaining high performers. Poor performers can be thoughtfully evaluated, and supported, re-assigned, or counseled out of the business if appropriate.

A clear understanding of the performance environment will provide essential guidance for setting incentive compensation expectations and designing meaningful plans.

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