Management is Needed – Not Incentive Compensation

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"Management must manage. An incentive comp formula will not be sufficient. "

Many theoreticians and more than a few executives take the position that incentive compensation is a powerful motivator and therefore it follows directly that careful crafting of the incentive compensation program is all that it takes to get the most out of a company's management team.

As an actuary working in a life insurance company where the executives believed that the right incentive compensation was key, I had the experience of modeling and advising on the development of a number of incentive compensation programs for the company's distributors. Once in place, the reaction of the distributors was always similar; some people ignored the incentive compensation program, some worked the program as was hoped by the designers, and a few abused the program.

For example, the company had a problem with low growth and they wanted to incent sales managers to hire new sales agents. So they added a bonus based upon the production of new hires and lightened (and in some cases eliminated) the penalty for hiring inappropriate people who were quickly unsuccessful. One sales manager figured out that simply by hiring large numbers of people who were often dubiously qualified, he could lower his unit cost of onboarding and collect that bonus on the new agent's sales to their close friends and relatives before they flamed out. The cost of sales for that agency was 30% higher than the rest of the company and very few of his new hires stayed on to actually boost company growth. None of the other sales managers found that strategy desirable. And the efforts of management to design the incentives for new hires to prevent that abuse discouraged everyone else further from hiring.

Another part of the company had a new bonus program every single year. They never seemed to get what they wanted. Their top sales office head was expert at finding the path of least resistance to maxing out on bonuses often without accomplishing any of the company objectives. The big problem that division had was that the top sales manager there was a very sociable and helpful guy. As he found the sweet spot every year, he immediately shared that knowledge with all of the other sales managers. So every year they did something different than what was wanted, got their bonuses and the SVP of that division sent the actuaries off to model a new version of incentive compensation, twisting and turning it to try to make it foolproof.

What is wrong with this vision of incentive compensation is the fundamental idea that somehow the right formula will motivate employees to do their best to advance the company goals by perfectly aligning incentives. Reality here is actually a complex adaptive system. Designers of an incentive compensation system are unlikely to be able to anticipate all of the variations of actions by employees, competitors, suppliers, markets and customers that can happen, even a single year out. And each action by one group causes reactions by one or all of the others.

Management must manage. An incentive compensation formula will not be sufficient. This applies to all corporate goals, including risk. And while risk managers want risk to be featured in incentive compensation programs, it is not necessarily the most important thing for most companies in most years.

Businesses have a hierarchy of needs along the lines of Maslow's Hierarchy of Needs for people. First in that hierarchy is the need to have a product or service that people will pay for. Second is the need to be able to deliver that product or service at a cost that is less than what their customers will pay. Once those two basic needs are satisfied, businesses become potentially valuable. The third need of a business then is to create some reliability of the profits of the firm through some form of risk management. When the first three needs are met, then the firm definitely has a value. The fourth need then is to increase the value. Increasing the value requires that the firm achieve some combination of increases to the amount of business (need 1), the margin on the business (need 2) and/or the reliability of the profits (need 3). There may also be a fifth and sixth needs for businesses, similar to "esteem" and "self-actualization" in Maslow's hierarchy, but that goes far beyond the scope of this discussion.

In many cases, plans to increase value will actually decrease one or two of the three elements to accomplish enough improvement in the third element to achieve overall value growth. Flawed plans that do not consider all three elements will often not actually deliver growth of value.

Which brings us back to the call for Risk to be included in incentive compensation. Employees need to understand the firm's strategies for satisfying all four needs. But it is usually much too complicated for incentive compensation formulas to reflect all four needs. That is where management comes in. Management needs to fully understand that the one thing that is emphasized in incentive comp is NOT the only need of the business. They need to communicate the multiple needs and strategies to achieve those needs to the employees that are under incentive compensation programs. And they need to provide ongoing feedback to all of their employees about how their actions enhance or detract from the businesses ability to meet all four of those needs.

Business managers cannot just set the right incentive compensation formula and then put their feet up. It is especially important for managers to make sure that they clearly communicate that there are other goals of the company that are not considered in the incentive comp. The "set the formula and walk away" approach leaves the employee with an airtight argument when they abuse the incentive comp system that they thought that they were doing what the company wanted from them. Employees who have the authority to put the health of the firm at risk need to have a clear expectation that doing so in a way that is inconsistent with the risk appetite and risk management program of the firm have not just their incentive comp, but their entire compensation at risk.

The root problem that needs to be addressed is the problem of allowing highly paid employees to work as if only one of the four needs is important. Their incentive compensation amplifies this wrongheaded job description. If the job description is fixed, the incentive comp can be just a nudge to increase emphasis on one of the four corporate needs. But that needs to be coupled with true management of those employees with all four corporate needs in mind.