How Motivated Is Motivated Enough?

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Introduction

Prior to the financial crisis, most people outside of the sector likely never gave compensation and incentive plan design a second thought. As the crisis unfolded and the government set out to identify the contributing factors, however, evaluating compensation practices became an important exercise for regulators and banks. The government's point of view was that banking organizations often rewarded employees for increasing revenue or short-term profit without adequate regard for the risk those activities posed to the organization and the financial system at large.

Ultimately, the government became concerned that these practices misaligned the interests of employees and the long-term safety and soundness of their organizations. Commission plans based on revenue or volume metrics epitomize this point of view, but it is important to keep in mind that regulators are also pushing the idea of "pay for performance," which is one of the fundamental characteristics of a commission plan.

As firms continue to evaluate their incentive plans, they will need to ensure that their plans reflect the three core principles of the sound incentive compensation policies that apply to all banking organizations:

1. They provide employees with incentives that appropriately balance risk and reward;

2. They are compatible with effective controls and risk management; and

3. They are supported by strong corporate governance, including active oversight by the organization's board of directors.

Given the diverse nature of financial services, it is not unreasonable to think that there are a limited number of businesses where a commission plan makes sense and can be designed in such a way that is incorporates the three core principles on incentive compensation. Although there are a variety of plan designs, including discretionary plans, target bonuses and scorecards, this article examines three approaches to commission plan design and evaluates each from employer, employee and regulator points of view.

Overview

For many years, many employees in financial services have been paid on some sort of commission basis. This appears to be a sensible arrangement, as it links an employee's pay to performance and makes pay more objective. In the last 15 years or so, however, the use of formulaic pay has diminished for a number of reasons – one being that firms simply do not want to be obliged to deliver outsized compensation to employees having remarkable years. This is particularly true if people perceive market conditions or franchise value as the source of the outsized performance rather than the efforts of the employee. In the last 15 years, the focus on "balanced scorecards" or more formal recognition of nonproduction factors in determining pay has thus also

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increased. These types of plans were critical when sales volume was significantly lower than previous years.

Though this movement away from commission or formulaic pay has taken place in some lines of business, particularly at the largest firms, a significant number of firms still pay sales groups on a formulaic basis. Adding color and complexity to the incentive pay discussion is a new regulatory environment for compensation, which in most instances aims to link pay and performance but does not unconditionally endorse commission-based pay programs.

Given this new regulatory reality, it is worth examining three approaches to commission schedules, how they motivate employees (or don't) and how they mesh (or collide) with the regulatory guidance. These three approaches are fairly well known, and all have their supporters and detractors. Numerous design features can be incorporated into and combined with each approach, but commissions generally take three simple forms.

1. Ascending schedules: the more an employee produces, the higher his or her commission percentage

2. Flat-line schedules: an employee receives a constant commission percentage, regardless of his or her production level

3. Descending or capped schedules: the commission percentage declines as the employee's production level increases.

Let's consider the core principles of each of the plan designs, keeping in mind that other elements of incentive plan design can be incorporated into each of these approaches. Some of these elements include deal caps, relationship caps, transaction caps, discretion, qualitative components, management overrides, etc.

Ascending Schedule

On the surface, this method seems highly sensible; the more you produce, the higher percentage of your production is delivered as compensation. The usual justification is that every job has a "seat cost" and that some measure of initial production covers this cost. For example, if a salesperson incurs $100K of non-compensation costs (the cost of the real estate he occupies, telecommunications, utilities, marketing, etc.) and $75K of support area compensation costs (administrative support, allocated HR, finance, IT, risk, legal, etc.), it's easy to argue that the first $175K of production could be fairly excluded from commission payments or that the commission (percentage) rate on the first $500K of production would be less than the commission (percentage) rate on production dollars above $500K (when "seat costs" would already be covered).

Regardless, the ascending schedule is a fairly straightforward method and, importantly, one that seems motivating. From an employee's perspective, the more you produce, the more you make, and the more incented you are to push even harder. If you hit your revenue targets at midyear, you are incented to double your efforts because increasing production will bring even greater rewards. From an employer's perspective, this type of schedule would be a significant driver of revenue, but at the same time the employer would need to consider carefully the inherent risks that accompany this type of plan. If there is a total compensation amount past which the employer no longer needs to pay a salesperson, for example, employers must weigh the appeal of higher revenues/profits from increased deal activity against the potential for potentially unnecessary above-market pay levels.

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An ascending schedule may raise red flags because it could fall out of line with the first sound incentive compensation principle of balancing risk and reward. From the regulator's perspective, the plan would need to adjust for risk either on the front end ("ex-ante"), back end ("ex-post") or both. One approach to the back-end risk adjustment is to defer increasing amounts of compensation as a salesperson works through the ascending commission grid. Another approach is to incorporate the individual salesperson's portfolio credit rating into the incentive plan goals and objectives. Last, a firm might pay deferred compensation in equity – for example, paying one-third of an employee's commission in stock over three years. Firms will certainly need to find ways to get creative with an ascending schedule given potential concerns about the safety and soundness of such a design.

Flat Line Schedule

In this scenario, employees receive a consistent commission percentage against their production, regardless of the production level. The rationale behind this is that a certain portion of the production is appropriately set aside for the employee and does not need to fluctuate with production levels. There is some sensibility to this as well: this approach delivers more modest pay than an ascending schedule, particularly in a year where market conditions may create unexpected and outsized returns that may not be the real result of outstanding individual contribution. This approach is somewhat common and can be a compromise between an ascending and descending, or capped schedule.

From a regulatory perspective, this approach partially mitigates the excessive compensation issue, as firms could back into the commission rate given anticipated volume and appropriate compensation levels. With a flat-line schedule, the employer is essentially determining a sharing rate up front, and regulators tend to view this approach more favorably as it does not provide a motivating factor to produce more just to earn a higher commission payment.

With this approach it is still important to review and address the firm's risk factors. A flat commission schedule can still provide negative results if the market is down or if the plan motivates employees solely based upon value. This type of plan should still address risk either on an ex-ante, ex-post or combined basis.

Descending or Capped Schedule

This approach is often the least favored from an employee perspective and thus can be the least motivating. In this case, employees get a decreasing percentage of their production as production levels increase. In some cases, the commission payment is capped.

The most common rationale for this type of plan is simply to limit "excessive" compensation. For some firms, there are scenarios of reward that feel intolerable, regardless of the remarkable production that may have created these scenarios.

Some firms support this method by making what may seem like a convoluted argument that this plan structure discourages excessive risk. They want employees working hard to produce, but if pay is too high in relation to production, the concern is that employees may take excessive risk. Though firms might say this is the outgrowth of risk aversion and in line with the principle of balancing risk and reward, descending schedules actually come with their own risk: demotivation. If commission payments are capped or steeply decrease as production escalates, a salesperson might have limited motivation to continue to produce once he hits his target. This risk seems as real as the idea that high payout rates encourage excessive risk.

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Capped or descending commission schedules also tend to cause misalignment between producers and shareholders when it comes to increasing revenue, which is generally one of the ultimate objectives in plan design. So, although we know that employees generally do not favor decreasing-rate schedules and employers have to think long and hard about the trade-offs, regulators would likely be comfortable with this type of plan. It demonstrates the principles of balancing risk and reward and does not allow for excessive compensation levels. One might argue that capping salesperson pay is a risk in itself and ultimately bad for the firm and shareholders, but we will have to see how that discussion plays out with the regulators.

Conclusion

For firms using a commission structure, today's challenge is designing compensation plans that motivate the employee, reward the firm, and comply with the ever-changing regulatory environment. A well-designed plan will be motivational while taking into account the use of capital and risk levels on both a short- and long- term basis and allowing for discretion where appropriate.

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