McLagan Alert
To Rate or Not to Rate: A Thoughtful Guide

By Warren Rosenstein and Levi Segal
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Overview

In recent months, with increasing frequency, we have read of firms eliminating performance ratings and "blowing up performance management". Few trends in Human Resources have had more momentum and, while this might not be a popular thing to say, have been misunderstood or done with less forethought. Support for dismantling traditional performance management approaches has been informed by employee feedback, research, and positive intentions. But what sometimes feels missing in firms' change processes are rigorously defined desired end states, and thorough reviews of the role that performance management and ratings (specifically) play at those firms. We believe there is a sweet spot between "transformative" and traditional performance management. It will look a little different for each firm, particularly in financial services, where highly differentiated compensation is at the very core of how firms operate – but the sweet spot can only be achieved through rigor and not a rush to join a crowd. In this paper we will look at what is changing, what are the intended outcomes, who are the stakeholders in this change, and what are the specific implications for rewards at financial services firms.

What is changing?

A number of firms, primarily in the Consulting and Technology spaces, have made changes to their approaches to performance management. The most high profile companies have included Accenture, Deloitte, and Microsoft. Their changes have been supported by research which indicates that traditional performance management is not having the desired effect. In addition, there's a general sense that given how involved performance management has become, it might not provide a reasonable ROI.

Be careful when reading the headlines. They can sometimes overstate the case, or even fail to fully capture what has actually changed. For example, at some firms there are now "shadow ratings" or other methods for codifying performance evaluation, such that the number of reward and human capital processes that require quantification can still operate effectively. Most common, is that a number of firms are encouraging more frequent feedback and doing away with forced rankings or distributions.

What do you want to have happen next?

What isn't always clear in articles on this topic, and in some cases ill-defined within firms that are considering these changes, is what exactly the desired outcome is. If we think of performance management as a cycle of goal-setting, performance evaluation, employee feedback and codifying performance or quantification (ratings), firms need to think clearly about what they want to change – is evaluation really going away? Quantification?

How you can respond

For direct consultation, please contact us.

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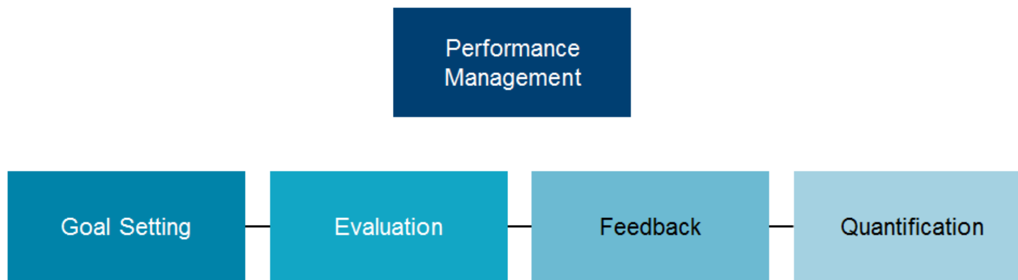
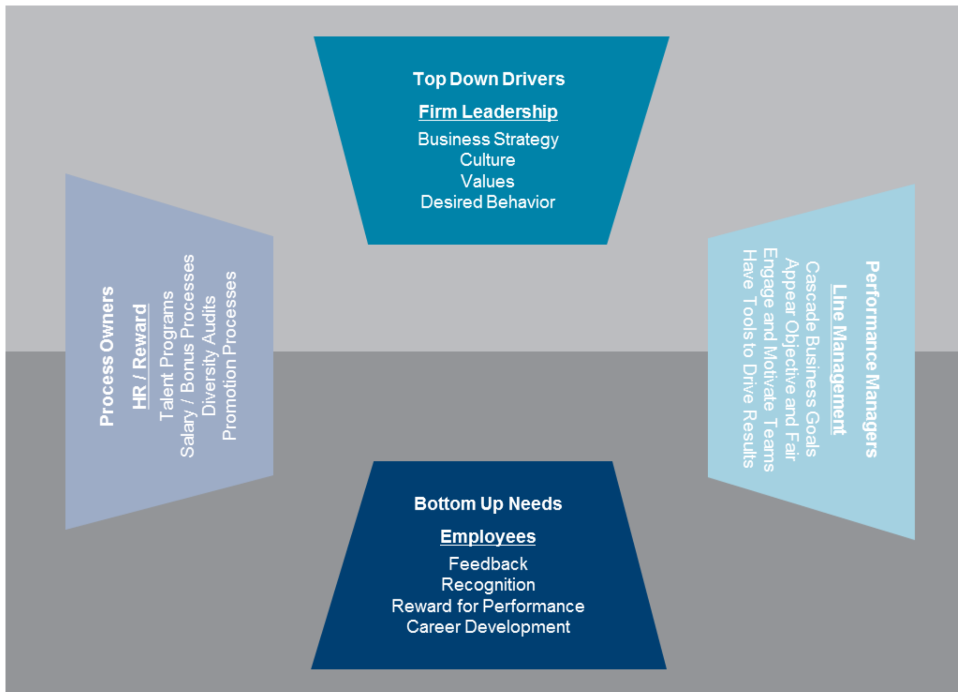


Consider the following pragmatic challenges before taking the leap to announce, “We are doing away with ratings.”

- If we are changing because the performance management process takes too long, is it really the quantification part that takes too long? What about the rest of it?
- If employees want more frequent feedback, does eliminating quantification help to do this?
- What should our balance be between setting goals versus measuring on competencies? And, if we exclusively evaluate employees on goal achievement, how do we ensure parity and objectivity in rewarding employees, without some kind of comparative quantification?
- How do we meet the needs of millennials in particular, who – contrary to popular belief – self-identify as being competitive, and want to be measured comparatively relative to their peers?
- How do we ensure that the feedback we provide is objective, and speaks about the one being rated more than the rater?
- If we find a single, annual rating process cumbersome and time-consuming, how will we manage aggregation / weighting of many feedback data points throughout the year?
- If quantification of individual performance is still part of the broader performance management process, and ratings are eliminated, what is to replace them?
- How will we attract and retain our strong performers, who provide exponential economic value to the firm, and research shows want to be a part of an organization that pays for performance? How do you pay for differential performance without differentiating employees?

Stakeholders

As we look at the performance management process stakeholders, we can identify four primary groups as being the end users of performance management. All have different invested interests in how well the process works.



Firm Leadership

The diagram above shows four primary sets of stakeholders in the performance management process. The "Top Down" driver of change has been firm leaders with strategic agendas, wanting to improve or abolish current processes. There is meaningful research, most notably the study by Corporate Executive Board, indicating the limited ROI on the current process, citing factors such as large amount of time invested and the limited impact to employees. There has even been neurological research cited, showing how employees go into "fight or flight" mode during the review and hear/absorb very little of the feedback. CEOs have heard this and are eager to be the forefront of the movement – in a number of cases they have simply mandated, "We are doing this, too." There are a number of top down needs that drive performance management and should be considered before making any change:

- What is our business strategy, and how does that translate into our talent strategy? What type of talent are we trying to attract? Retain? Motivate?
- What is our firm culture? Values? If we are a meritocracy, for example, how do we ensure that we recognize, quantify and reward outstanding contributions?
- What are the desired behaviors we want to see? Innovation? Collaboration? Better execution? Client service? How do we identify these and make these goals pervasive, and – of course – how do we reward these?
- Does our business model rely more heavily on teamwork or individual contribution? Does individual measurement and quantification somehow discourage teamwork?

- How do we drive a culture of pay-for–performance – a particular financial services challenge for leadership – and still guard against incenting employees to take excessive risk or act in an inappropriate fashion?

Employees

Certainly the most critical stakeholder group in the performance management chain is the employees themselves. Today's employees increasingly crave feedback. But, is it praise or feedback they really want? Let's assume the best – a number of engagement surveys have shown that employees want feedback, they want to be developed, and interestingly – particularly in the context of firms eliminating ratings – employees want to benchmark themselves competitively. They want to know where they stand relative to their peers.

So this brings us to a cross-road. Some of the energy around removing performance ratings seems linked to the "soccer generation" mentality – where everyone gets a trophy. Is it too harsh to give someone's performance a numerical rating? Isn't everyone a winner? Shouldn't everyone "far exceed expectations"? How do we best serve these employees, who self-identify as craving feedback, but we seem so reluctant to be direct with?

What else do employees want out of the process? Certainly, and fairly, they desire recognition. And employees want to be rewarded for their performance. A well-accepted truth in reward strategy is that employees often care more about the fairness of their pay (pay equity) than the actual dollar amount.

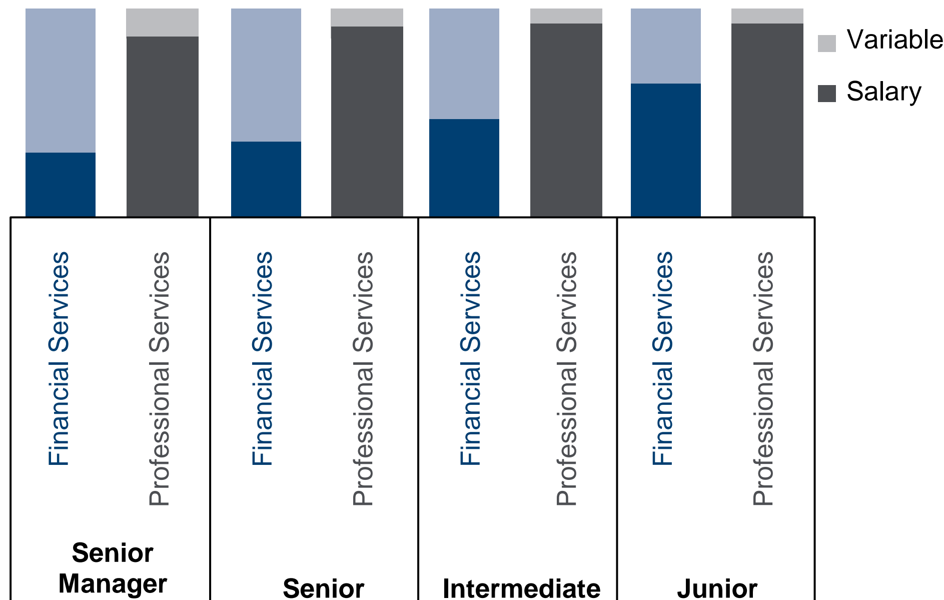
And a well-known phenomenon of the internet generation is that everyone winds up knowing what everyone else is paid, whether through websites or gossip. So, more than ever, it is critical that pay seem fair, objective, and directly linked to performance. As we think about changing our performance management strategy, are we implementing changes that make pay seem more transparent or more opaque? If employees almost universally asked for more clarity around the link between performance and reward in the presence of ratings, what will we have to offer them once ratings are gone?

Process Owners

Often not considered in the initial wave of change, and in many cases served by concepts like "shadow ratings", are the many processes that use performance ratings in the Human Resources and Reward functions. Consider all of the procedures, such as salary increases, incentive awards, and talent identification / development programs, which rely on performance ratings. Think of what it would be like to identify high potentials or successors without quantifying performance? Or trying to ensure pay equity without performance differentiation – what tools do we use to look across employees to review fairness of pay levels related to performance? Very small firms may need to rely on this less, as well as firms / industries where differentiation isn't a focus. In financial services, where pay rates vary widely based on contribution, how do we make certain these variations are fair and based on merit?

For reward in particular, there are unique challenges in the financial services space that may lead us to rely more heavily on ratings/differentiation than in

other industries. The following illustration is indicative of how much more of a variable pay focus there tends to be for financial services firms:



Consider the following factors as being particular, if not uniquely positioned as financial services concerns:

- The greater use of incentive pay in the financial services industry means that with more variable pay, we need more precise tools to distribute this variable pay fairly.
- Highly volatile year-over-year performance (for example, a trader might lose money one year and make money the next, a phenomenon that would be less typical in an industry like consumer goods, for example). How do we link pay to performance if we don't quantify performance, when we know performance varies so meaningfully?
- The hours worked and effort put in inherently creates bigger performance gaps between individuals – firms need to quantify these. While the need for teamwork and collaboration is high, business lines and products are uniquely driven by individual efforts, so a more one-size-fits-all approach on differentiating compensation won't work here.
- As some firms have moved away from pure commission as a primary sale compensation tool, we see more and more balanced scorecard approaches that involve assessments of qualitative factors. These qualitative factors need to be blended with quantitative measures and codified, in order to trigger specific payouts.

Performance Managers

Much of the discussion around the missing ROI on traditional performance management focuses on performance managers and the amount of time these processes require. Managers need tools to set goals, to encourage employees to meet them, to create trust and transparency with their teams. These managers and their relationships with teams are the real places where high level business strategy turns into tangible action plans and where accountability for outcomes takes place. In some ways this group of stakeholders' greatest role in the process is that of being an efficient conduit / facilitator of other stakeholder needs.

Two very real challenges for this group are as follows:

- If we are already concerned with the amount of time this group spends on performance management, how will that change with mandated weekly / monthly check-ins – certainly employees stand to benefit from this, and the greater focus is ROI versus aggregate time invested, but have we taken a real look at the implied time commitments?
- The transformation from "rating to coaching" places more responsibility on the very group that wasn't doing a very good job to begin with – the performance managers! If we were concerned about poor goal-setting, inconsistent applications of standards, etc., are we possibly doubling down on the performance managers having more discretion / spontaneity / individual approaches? And why do some assume that providing ratings and coaching are mutually exclusive? Managers should be doing both. Rating versus coaching is a false choice.

What to do?

Knowing the optimal approach will be different for each firm, but there are core principles for success that are universal. The changes below may seem like no-brainers but firms will realize fast returns on these:

Universal

- Forced rankings or distributions have generally fallen out of favor, and appropriately so. High performing teams should not be forced to rank some fixed percentage of their employees below average, to meet a standardized distribution.
- More frequent, brief check-ins are becoming common in the new paradigm and this is a can't-lose approach, assuming an improvement in the quality of performance manager feedback skills and tools. Whether these check-ins are tech-enabled, or simply a monthly check-in on a calendar, employees deserve consistent feedback, and managers themselves will benefit from increased group performance. Employees should not approach a year-end performance appraisal with no idea of what to expect – if this is the case, the process has broken down.
- A large number of competing goals (more than 5 or so) or a complicated schedule of 360 degree reviews / feedback may not provide reasonable ROI. It is better to have a smaller number of well-defined goals than a laundry list of objectives that cannot possibly be achieved, and do not get appropriate focus.

- Consider the optimal balance of measuring goal achievement and competencies that fits your business – ensure that people are reasonably measured based on what they get done, but also have enough tools to make internal comparisons.
- Firms are thinking about more thoughtful language than simply “meets expectations”, which seems formal and unappreciative. There is also the issue of whether a higher performer automatically creates higher expectations. That said, firms that expend a lot of energy going back and forth (in some cases annually!) from 3 point to 4 point to 5 point ratings scales are wasting time. The 3 point scales are not adequate to differentiate between the kind of performance that is really outstanding, and firms shouldn’t expect employees to perform at levels they find too challenging to identify. The best practice firms spend time training managers how to be objective, and to set clear goals around what is “excellent” or “far exceeds”. Firms that tell staff they can’t identify outstanding performance shouldn’t expect it.

Customized
Beyond the common sense changes identified above, consider this as a simple process map for defining an improved future state:

- **Data Gathering** - Interview the four stakeholder sets. Hear their needs with an open mind. Gently challenge preconceptions where possible. It is possible that the firm leaders don’t understand the data points needed by the process owners (to drive the firm’s business and talent strategy). It is possible that the performance managers don’t understand the kind of feedback the employees need. When you have a clear view of the desired end state for each of the groups, look at the overlap. What does everyone want? Need? Where are the conflicts? Observe what has worked well in the competitive market. Where possible, peek behind the scenes at where other firms have struggled and avoid these pitfalls.
- **Analysis** - Consider each of the four phases of traditional performance management: goal-setting, evaluation, feedback and quantification. How can these be modified to better meet the needs and interests of the stakeholders? Where there is a conflict in the needs of these groups, develop an approach for identifying which needs take precedence. Working backwards from the identified needs, construct a straw man model to support these needs. Challenge group think / prevailing wisdom. If employees want more feedback, does that mean they can’t have ratings? If management wants more teamwork, does that mean a balanced scorecard with teamwork as a ratings category, or do we need to eliminate ratings to have teamwork? Think about what has worked well in the past – be mindful of preserving existing value and eliminating wasted motion.
- **Review** - Show the straw man model to representatives of the four stakeholder groups. Get feedback. Will it meet all of their needs? Make modifications based on feedback. At a large firm, consider piloting the updated process with a small group so there is an opportunity to flush out unforeseen snags.

In Conclusion

Challenging convention is always healthy, and the energy around changing performance management will likely lead us all in a good direction. Firms approaching this topic thoughtfully, going beyond the headlines, will achieve improved outcomes. Much of the change that has already taken place provides a roadmap for what will and what may not work. And of course, what works for one firm may not work for another. Consider your firm's business strategy, the values, the culture, and most simply consider what you want to have happen next before taking a leap. If you approach this thoughtfully, it should be easy to "far exceed expectations" – the thing we all want to do!

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