DESIGNING EFFECTIVE REWARD SYSTEMS

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DESIGNING EFFECTIVE REWARD SYSTEMS

How can a business design reward systems appropriate for the current economic crisis? **Wim Van der Stede** proposes constructive ways to improve incentive systems.

The banking industry has been criticised for rewarding excessive risk-taking with its 'bonus culture'. At the same time the downturn means that many organisations will be reviewing their 'pay-for-performance' plans. The question then is, how can this best be done? I propose that organisations scrutinise three elements of their reward systems:

- incentive strength;
- incentive type; and
- incentive horizon.

Incentive strength – consider weak(er) incentives
In an earlier article about the pitfalls of pay-for-performance[1], I argued that incentives have the indisputable effect of focusing employees on what is rewarded. 'What you measure is what you get', the saying goes – but does it always work as intended? Strong incentives would be just fine if what you measured, and rewarded, matched what the organisation wanted. But that is hardly ever the case due to measurement problems and multi-tasking.

Measurement problems – examples of measurement problems are not hard to find. Schools want to improve education, but they measure improvements in test results. Hospitals want to improve health care, but they measure treatment costs. Firms want to enhance shareholder value, but they measure annual profits. If what is measured is what is rewarded, organisations are likely to see progress in measured performance, even though measured performance may not match intended performance. Worse, organisations may see improvements in measured performance to the detriment of intended performance.

Indeed, 'teaching to the test' – a possible unintended consequence of rewarding teachers for improved test results – should not be equated with improved education. Equally, focusing on treatment costs in hospitals – the measured performance – may divert attention away from prevention, which might (albeit perhaps with delay) reduce the need for, or improve the effectiveness of, treatment.

There are also a number of ways in which for-profit firms may increase annual profit without creating long-term value, or worse, while destroying it. For example, managers can push employees into overtime or hire temps at the end of a measurement period so that more

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product can be shipped and higher revenues and profits reported. But if product quality suffers, customer satisfaction may diminish, the cost of customer returns may increase, and some employees may become disgruntled and disengage or leave. Goodwill that had been built up previously may be lost. So the effects of such measurement imperatives are counterproductive.

As these examples show, incentives 'work' in that they focus employees' attention on what is measured and rewarded. But it is only when measured performance adequately captures what is intended for improvement that strong incentives will have good effect. When that 'match' – between measured and intended performance – is incomplete, then strong incentives will only stimulate unintended or 'perverse' behaviours. Put bluntly, when incentives are misdirected due to poor measurement, they only take the organisation off course, faster. Thus, when measurement is likely to be problematic, organisations are better advised to weaken incentives rather than strengthen them.

Multi-tasking – hard as it is for any measure to completely, or sometimes just adequately, capture intended performance, it is just as hard to define jobs – even seemingly simple jobs – by a single dimension in terms of what is desired by the employee for performing the job effectively. That is, most jobs are multi-dimensional: they require multi-tasking[2].

For instance, banks may have thought that the job of their mortgage personnel involved 'generating mortgages' (indeed they often motivated these employees by paying straight commissions on the face value of the mortgages sold), but what good does it do to have 'bad' mortgages on the books (as many banks have pitifully found out)? In fact, generating 'good' mortgages involves not just selling the highest number of loans at the highest possible face value but also assessing the creditworthiness of the borrowers, among other things. Commission-type incentives based on the face value of the mortgage are likely to 'crowd out' such concerns, thereby reducing what is essentially a multi-tasking job (one that involves trading off loan amount vs. risk; current business vs. future profitability) into a single-tasking focus, which it is not. Conceptually, employees respond to what is signalled by the incentive system as being important (what is measured) and what they are rewarded for (what is incentivised). But when what is measured is incomplete, the incentives attached to it are likely to lead employees to devote less, or sometimes no, attention to important-yet-unrewarded activities that are just as critical, sometimes even more critical, for success. The incentive system is imbalanced, with strong incentives on one dimension crowding out the desired attention by employees to other important dimensions of their job.

Yet providing strong incentives on all of the important dimensions is likely to prove unfeasible and too costly, so it follows that providing weaker incentives – that is, incentives that are proportionally smaller relative to salary – might be the best option available to prevent the imbalance from getting out of control.

In addition to reducing the incentive strength on any one dimension, another way to address the incomplete-measurement problem, and to keep incentives balanced, is to consider subjective performance evaluations.

Incentive type – consider subjective performance evaluations

When subjective performance evaluations are used, part (or all) of a bonus is based on subjective judgements about performance: this allows organisations to utilise any relevant information about an employee's

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Subjectivity can be used to reward or punish employees for value-enhancing or value-destroying efforts outside the bonus formula

performance that arises during the period. Of course, subjectivity, if used, needs to be contractually authorised in the bonus plan. This is not just for legal reasons. If employees do not understand the key elements of their bonus plan, it is unlikely to generate the desired motivational effect.

My key focus here, however, is that subjectivity allows for the rebalancing of incentives, such as to improve multi-task incentives[3]. For example, if a mortgage sales rep is deemed to have been performing below standard, then that employee would miss out on all or part of the eligible discretionary bonus. In other words, subjectivity can be used to reward (punish) employees for value-enhancing (value-destroying) efforts that are otherwise too complex or too costly to quantify in the formula bonus contract. In so doing, the organisation signals that the other dimensions of the job at least receive some weight, thereby possibly mitigating otherwise narrow or 'perverse' behaviours.

When the subjective evaluation processes are done well and kept honest, and when the judgements are substantiated, such discretionary bonuses can be far superior to mute aggressive 'bonus cultures' that are predicated on generating short-term results, regardless of the consequences.

Incentive horizon – keep focus on the long term

A final problem with incentive systems is illustrated by the recent banking crisis: namely, that in many of the banks the vast bulk, if not all, of the incentive pay was based on short-term performance, particularly at levels below the most senior executives. When it became apparent that in some cases the stratospheric short-term profits were unsustainable in the long term, the bonuses had already been paid and there seemed no way to claw them back.

What this demonstrates, again, is that incentives 'work' – ie, when they focus on profits measured in short periods, then employees tend to be highly concerned with increasing monthly, quarterly or annual profits. When employees' orientations to the short-term become excessive, however – so that they are more concerned with short-term profits than with long-term value creation – they are said to be myopic.

How can incentives be designed to mitigate myopia and encourage employees to have a long-term focus, or better still, to balance their concerns for both short-term profitability and long-term sustainability? Here is an example of an attempt at such mitigation; surely not perfect, but nonetheless worthwhile analysing.

To improve incentives to capture the long term, UBS – a global bank – recently changed its traditional annual bonus plan for managers below the executive level to tie rewards more closely to sustained performance. Specifically, UBS's new incentive plan stipulates that cash payouts will be restricted to a third of a manager's earned bonus in any given year. The other two-thirds will be rolled into the manager's bonus bank, which can go up or down depending on performance in the following year. The so-familiar 'bonus' therefore can become a 'malus' in years when the balance in the bonus bank is adjusted downward. UBS also changed how performance is measured to reflect risk-adjusted profits[4].

Although only limited information is publicly available about this UBS incentive plan, the redesigned incentive system changes the measurement focus from short-term (annual) to long(er)-term (triennial) on a rolling-forward, adjustable (up or down) basis. This should curb employees' propensity to be excessively focused on performance in the current year regardless of how their decisions might affect future profitability. In other words, the triennial rolling-forward feature of the bonus system might lead to a better balancing of short- and long-term performance.

In addition, adjusting the performance measures for risk – where nominal performance is discounted to reflect the risks involved – principally addresses the balancing of performance and risk, which is another often overlooked aspect of traditional incentive systems. To stay with the mortgage example, one possibility is to adjust current profits for expected losses based on probability models of default and loss. But while the concept seems fairly straightforward, calculating the risk-adjusted measures by activity can be analytically challenging, which makes these measures, at least in part, contentious for those evaluated on that basis.

Finally, because the 'mental' discount rate that employees apply to delayed incentives is said to be higher than the financial discount rate used to determine the present value of money, organisations cannot simply delay all of their incentive payments until years later. The feature of paying one third of the earned bonus in each year might therefore strike a reasonable balance between delayed pay and the need to keep the long-term focus. And because two-thirds of the bonus remains in the bonus bank on an adjustable basis, a 'malus' mechanism is created to claw back a reasonable portion of the bonus that might subsequently appear to have been based on unsustainable performance.

Transcending this specific example, the notions of deferment, risk adjustment and possible clawback also appear as recommendations in the recent Walker Report on banking bonuses. This report says:

"As to the short-term bonus, which rewards the executive for performance in the current year, the proposal is that payments under any award should be phased over a three-year period, with no more than one-third in the first year"[5];

"remuneration schemes cannot impose negative consequences on an executive equivalent to the positive outcomes, and thus risk adjustment in remuneration structures is essential to counterbalance any executive disposition to increase risk as the means of increasing short-term returns"[6]; and, finally

"clawback should be used as the means to reclaim amounts in limited circumstances of misstatement and misconduct"[7].

Conclusion

Since 'what you measure is what you get', and because incentives 'work', it is clear that strong incentives will have strong effects – both good and bad. So if what is measured is not what is intended, strong incentives will only get the organisation faster to the undesired result.

Moreover, while it is rare for incentives to be focused on an entirely flawed measure, it is equally rare for any measure – even one of the 'best' ones – to capture all of the dimensions that are important for sustainable performance. And if incentives do not fully capture all of the important dimensions of a job, then employees are likely to restrict their efforts to the measured tasks at the expense of other important-but-unmeasured tasks (eg focusing on booking mortgage sales while ignoring risk). To mitigate this problem, the weights placed on at least the key dimensions of the job will have to be rebalanced so that one dimension is not incentivised disproportionally relative to the other(s).

Such rebalancing is often hard to do, and may require muting incentives on dimensions that used to be strongly incentivised (instead of also incentivising all of the other dimensions equally strongly, which is likely to be unfeasible and too costly). An additional way to try to capture the multi-tasking nature of jobs is to reward employees subjectively through discretionary bonuses for value-enhancing efforts that are not easily quantified in formula contracts (eg quality of credit analysis, customer care). That, too, is not a panacea, but it can set the tone for a culture change away from a make-or-break 'bonus culture', where what is made now often appears broken later.

Finally, a further important aspect of measurement incompleteness is that formula bonus plans often induce an excessively short-term focus, especially when bonuses are based on annual (accounting) performance. Employees then often take actions to improve short-term performance without creating long-term value, and sometimes even by destroying it. To mitigate this, organisations could consider redesigning their incentive systems to capture (risk adjusted) performance measured over longer periods and/or to allow clawback of any undeserved bonuses over time.

Most incentive systems are far from perfect – worse, they are often seriously flawed. It is therefore important to understand where the incentive systems fall short and how those shortfalls can be addressed. Distorted incentives, when left unchecked, can have devastating effects – as recent events would seem to show! ■

REFERENCES AND FURTHER READING

1. Wim A Van der Stede, 'The Pitfalls of Pay-for-Performance', *Finance & Management* (December 2007), pp. 10-13.
2. For a more detailed treatment of the concept of 'multi-tasking' in accessible form, see, for example, John Roberts, *The Modern Firm* (Oxford, 2004), and other work by this author and colleagues.
3. See also Mike Gibbs, Kenneth A Merchant, Wim A Van der Stede and Mark E Vargus, 'Benefits of Evaluating Performance Subjectively', *Performance Improvement Journal* (May-June 2005), pp. 26-32.
4. From: *The Economist*, 'Payback: Bankers' Pay is a Complex Subject that Arouses Simple Emotions' (20 November 2008).
5. Sir David Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities' (16 July 2009), p. 97.
6. Ibid., p 98.
7. Ibid., p 98.