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Management is Needed: Not Incentive Compensation

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Many theoreticians and more than a few executives take the position that incentive compensation is a powerful motivator. It therefore follows 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 an insurance company where the executives believed that the right incentive comp was key, I had the experience of modeling and advising on the development of a number of incentive comp programs for the company's distributors.

Once in place, the reaction of the distributors was always similar; some people ignored the incentive comp 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 incentivise 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.

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

Employees need to understand the totality of the firm's strategies. But it is usually much too complicated for incentive comp formulas to reflect all of those strategies. 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 comp 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 of those needs.

Business managers cannot just set the right incentive comp 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.

*This is an excerpt from an essay that was awarded first prize from **THE JOINT RISK MANAGEMENT SECTION (JRMS)** of the Society of Actuaries (SOA), the Casualty Actuarial Society (CAS), and the Canadian Institute of Actuaries (CIA).*

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