PERTH LEADERSHIP INSTITUTE

White Paper

COMPENSATION STRATEGY AND ECONOMIC CRISES: TIME FOR A RADICAL RETHINK

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www.perthleadership.org
(352) 333 3768

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Compensation strategy has evolved as a technical discipline. It has signally lacked a behavioral focus on what drives good financial outcomes. This explains many of the excesses in compensation that helped cause the current economic crisis.

Compensation strategy and approaches are stuck in a pre-behavioral age. In order to restore relevance, compensation specialists must move forward to become strategic rather than technical in their outlook.

Part 2: The Age of Behavioral Finance

Behavioral finance has changed the name of the game. But the compensation profession has not caught up with it yet. If they don't, sooner or later it will become irrelevant.

A new model of financial behavior allows us to identify and measure financial behaviors and link them directly to financial and valuation outcomes. This is the missing link that compensation people need to make the move to a behavioral focus.

Part 3: Moving Forward

The new model makes most sense with high-impact players. The rationale is to achieve very high-performance with safety. This will require the compensation profession to retrain and regroup.

The most impactful and innovative move is to integrate performance management with talent development. Many companies will balk, but this is the way we avoid future economic crises at the firm and at the global level.

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COMPENSATION STRATEGY AND ECONOMIC CRISES: TIME FOR A RADICAL RETHINK

Part 1 Where We Have Been

Compensation Strategy – Time for a Change

Compensation strategy has received an inordinate amount of attention recently because of the widely-felt perception that it has resulted in inequitable treatment of CEOs and other highly paid people such as bankers. There is a growing feeling that, somehow, modern compensation strategy may be at the root of many of the pervasive economic problems facing the US. Much of this feeling is due to the perception that compensation objectives in the past 10 years have actually been in conflict with both shareholder and broader social goals.

It has become increasingly clear that, for all the time and effort invested in developing modern compensation systems, current compensation practices and strategies have had far-reaching unintended consequences which have exacerbated the many other adverse factors driving current economic and financial problems. These consequences, which started at the microeconomic level, have had consequences at the macroeconomic and the global level.

There aim of this White Paper is to explore some of the deeper issues underlying conventional compensation strategy and to suggest ways to address some of them.

Compensation Strategies Played a Significant Role in the Current Crisis

It is clear that current approaches to compensation played a significant role in the current economic crisis:

- The obvious example is the high levels of CEO pay, driven by agreement between boards and compensation specialists on these levels.
- It is also clear that many compensation plans, particularly but not only in the financial institutions, provided perverse incentives for individual employees to profit at the expense of shareholders, even so far as encouraging them to make bets which, if they were wrong, could cause a firm to fail, as actually happened
- Even where company failure did not occur, compensation plans have been associated with continuing declines in the worth and performance of numerous companies, e.g. the auto companies.

- Compensation plans for particular individuals in numerous companies and industries have actually brought out the worst in them by motivating them to go to extremes which were bad for their own companies and shareholders.
- Compensation plans focused on ever-higher performance that did not take into account behavioral vulnerabilities of the employees which would likely be triggered by these plans.

"….the overall trend of compensation plans has been to drive for ever-greater performance without an understanding of the behavioral pitfalls and perverse consequences that they could trigger…."

Of course, this is not to say that all compensation plans were at fault. Many people did not act in the extreme ways that they were encouraged to by some compensation plans. Other companies had more responsible compensation plans. Other compensation plans at numerous companies had good effects, but these were swamped by the excesses in other companies

The problem was far more serious at more senior levels in organizations, particularly with high impact players in the financial institutions, than at less senior levels. Many companies had codes of ethics that protected them from being directly impacted, even though they were impacted by the problems of others. Probably the vast majority of employees acted responsibly in the run-up to the crisis.

But there is no denying that the overall trend of compensation plans has been to drive for ever-greater performance without an understanding of the behavioral pitfalls and perverse consequences that they could trigger. May of these plans was generally not designed with any formal consideration of behavioral vulnerabilities that could cause systemic problems at the level of the firm and of the overall economy.

As the problem in the US has grown over the last few years, most people acted responsibly, but many others didn't. Compensation strategy doesn't formally distinguish between the two. Is it reasonable that it should do so? Should compensation strategy address behavioral vulnerabilities that would cause an otherwise good compensation plan to have toxic effects? Does a framework exist to enable for compensation specialist to be able to do this, even if they wanted to?

The response from many would be that compensation specialists are not psychologists or behavioral experts. But should they be?

Does the compensation profession need to change so that it is attempts to predict unintended consequences of compensation systems and their potential adverse impacts? Should they be able to understand how employees can game the system, and be able to design compensation systems that do not allow this? Should they understand what the differences are between people who will game the system and those who will not? Should they also understand the links between different behavioral types and the likely financial outcomes so that they can design their systems to be less likely to have pernicious effects in the longer-term?

Many compensation specialists might say no to these questions. But the potential danger to the overall economic system is so great that leaders in this area need to formally consider these issues. They need to look critically at their own approaches to take away lessons that could improve their performance in the longer-term. Companies also need to review their performance on these same criteria. A crisis like the one we are undergoing now is an opportunity to look critically at what went wrong and how we can change things for the better. This White Paper is offered up in that spirit.

Compensation Must Transition from Technical to Strategic Behavioral Discipline

Compensation strategy has traditionally been seen as being primarily a technical, mainly financial task. Those designing compensation plans identify their objectives and then use one or several techniques, or pay plans, in order to achieve them. The pay plan is so designed that there is a direct link between the objectives and the resulting outcome on the part of the employee.

On the part of the organization, there are four major objectives:

- Achieve strategic objectives
- Attract and retain talent
- Increase organizational valuation
- Increase shareholder wealth

In regard to the impact on employees, pay plans have an additional three objectives:

- Maximize performance, including financial performance
- Increase employee morale, satisfaction and productivity
- Encourage wealth accumulation for the company and the individual

We might wish to term the traditional model of compensation, an <u>objectives-led</u> model. This might seem unremarkable since surely the aim of any compensation strategy which aims to maximize organizational and business performance should do precisely this. But as this White Paper will argue, there is an alternative and it is an important one that has been neglected. That neglect has likely contributed significantly to the problems we are now seeing at both the macroeconomic and the microeconomic levels.

Traditional Approaches Neglect Vital Issues

Compensation experts are well aware of several significant problems with the traditional approaches. Some of these include:

Organizational factors: Some organizations will value certain approaches that may be adverse to value creation that will persist even when compensations systems are ostensibly targeted to maximize profitability and valuation. The auto companies are classic but hardly the only examples. These companies persisted with organizational processes and values that led to organizational failure despite (or because of?) compensation systems that were ostensibly designed to do the opposite.

Professional factors: Some employees will not act the way they are compensated to act, even though they will not maximize their compensation as a result.

"…..compensation plans on their own are not sufficient reasons for many employees to act in the way that they are compensated to….."

A classic example is employees in health care companies who will frequently act to maintain what they see is an adequate or excellent standard of care, even if they are compensated for reducing costs; this frequently occurs with salaried doctors for example. This example is in fact typical in industries or amongst professional occupational groups such as engineers, health care practitioners, auditors and the like. In these cases, many employees will prioritize quality over cost even when they are compensated to do otherwise.

Behavioral factors: There are numerous behavioral factors impacting compensation systems and outcomes. These particularly include financial traits such as frugality or its opposite. For example, some employees will use more resources than others would see as being prudent because they believe that these additional resources will more than pay for their cost at some point in the future, even if it is an indeterminate point.

We see this frequently with certain types of CEOs and leaders who will utilize additional resources even when compensated to produce short-term profits. It might be argued that their compensation plan was not at fault, just the execution by the CEO. But the point is that if a compensation plan does not attempt to address such behavioral issues, it might be fatally flawed at the outset so that's its very design is flawed too.

It is abundantly clear that compensation plans on their own are not sufficient reasons for many employees to act in the way that they are compensated to. This is not the same as arguing that compensation plans never work or that they are ineffective in meeting their design objectives. In many cases they do achieve them. However, what is clear is that we cannot assume that this will always or even usually be the case. Other factors will intervene including professional, personal and organizational factors. Unless these are adequately addressed, compensation plans are not likely to meet all or even most of their ultimate goals of achieving higher but sustainable and responsible performance.

….Notably the Behavioral Issue

This White Paper will focus on just the behavioral issues, especially financial behavioral issues. Put simply, compensation strategies are behaviorally blind in this context. They assume that, within the class of employees that they are targeting, the non-behavioral differences are the significant ones while behavioral differences, particularly financial behavioral issues, are not significant in influencing financial outcomes, in practical terms.

The current compensation paradigm is for strategy to focus on three types of differences between employees:

- By function, such as sales, product development, or administration
- By level, such manager, vice-president or director
- By impact, such as no P&L responsibility, P&L manager, cost-center manager.

Compensation strategies focus on groups such as these and design pay plans that aim to increase performance within the particular group, based on their targeted objectives and performance and given the level of control they have that can influence the outcome.

"….compensation plans are usually functionally and not behaviorally-based…."

Let us look at examples of the differences that traditional compensation strategies do <u>not</u> address:

> **Two salespeople who are being compensated to drive profitable sales growth.** One is very focused on helping the customer and feels a close bond with them. The other is much more focused on making sure the sale makes money for the company. A traditional sales compensation plan will not distinguish between the two. Yet clearly the two have different motivations and drivers and will need different types of plans.
>
> **Two P&L managers, who are being compensated to drive profitability.** One is sales-oriented and will do whatever it takes to drive sales growth. The other is much more profit-oriented, even if he is not compensated to do this. Again each should require a different compensation model based on their natural predilections and capabilities but both will usually get the same compensation plan.

The problem in each case is that the compensation plan is being applied to a job function without recourse to the natural behaviors of the individuals involved. Each has natural behavioral strengths and vulnerabilities. The job of a compensation plan in this case is to encourage them to adopt behaviors that will encourage them to compensate for their vulnerabilities while still encouraging them to use their natural strengths in a way that will not imperil the fundamental goals of the firm over the longer-term.

In other words, compensation plans are usually functionally and not behaviorally-based. They take account of functional and job differences but not of behavioral differences. In some cases the compensation plan may work notwithstanding. In many other cases it will not. It will most certainly never get an optimal result since it is not customized to the precise behavioral drivers of the individual.

In sum the problems of the traditional compensation approach are:

- They assume that a logical, top-down approach to compensation based on a direct logical linkage between objectives and compensation is the best, if not the only, way to approach the problem
- They assume that what seems to be logical for the employee means that the employee will necessarily act that way.
- They assume that the same type of pay plan will work for any type of individual within a particular category that is not defined behaviorally given, that is, they are behaviorally neutral.

Compensation Strategy is Stuck in the Pre-Behavioral Age

The roots of compensation strategy lie in models of the firm which are based on systems approaches. These approaches stress that there is a deterministic link between inputs and outputs – that is, in the case of compensation, pay rules which are the inputs and good behaviors on the output side. This is above all a rationalistic approach. It assumes that outputs will bear a logical approach to inputs and that these will essentially be the same for all individuals within any job or functional class.

Compensation models take their lead from the models of Taylor and the Sloan school of management. The link between rules and behaviors is a technical issue. Once a practitioner understands the models and the rules, the rest flows naturally since it is determined by a basic set of pay and compensation mechanisms that can be mixed and matched according to the situation.

Of course, there are a lot of job and functional classes and a lot of jobs and industries. That makes for a rich profusion of ways to come up with the right mechanisms and pay scales.

"…..The link between rules and behaviors is a technical issue….."

Compensation strategy today revolves around matching the jobs and functions to prevailing pay scales and compensation rules of engagement as set in this technical model. Thus modern compensation approaches are actuarially focused, as befits the technical nature of the discipline. The tools of compensation strategy are surveys, job categories, performance objectives, and defined outcomes. This would be a really neat model if only there was not the intervening existence of human behaviors.

Human behaviors are not always or even primarily logical or rational. We have come to understand this more and more with modern studies in neuroscience and with the mergence of the disciplines of behavioral finance and behavioral economics. These disciplines eschew the simplifying assumption that human behaviors are always rational and make things more complicated by integrating into their models the existence of non-rational behaviors. These disciplines call this a model of mixed rationality.

Traditional compensation strategy is based on an economic and financial model of fully rational behavior within bounded universes consisting of logical models of the organization. Compensation models have not yet moved to the point of admitting into their calculations purely behavioral considerations, and particularly the issue of behaviors which are mixed in terms of rationality.

Compensation strategies today are based on models of purely rational behaviors, rational economic and financial decisions and logical relationships between inputs and outputs. Unfortunately modern scholarship is rapidly moving in the opposite direction. That direction has been further catalyzed by the numerous unintended consequences we have seen in compensation strategy as applied to CEOs and Wall Street players where compensation strategy clearly did not foresee the results of its approaches.

Compensation strategy is above all rational. But financial panics and busts show clearly the limits of such rationality. In order to remain relevant and to catch up with where modern social – and medical –science – is headed, it needs to start to incorporate non-rationalistic factors into its models and above all to show how compensation impacts and is impacted by the varying types of financial and other behaviors of individuals, non-rational as it sometimes may be.

But Not all Behaviors are Equal

In talking about behaviors, we need to be more precise. We can categorize a variety of behaviors. Many of these are identified and measured by traditional personality assessments such as the Myers-Briggs, the Hogan, Kolbe, Five Factor model and so on. These fundamentally deal with thinking styles and social interactions.

Other types of behaviors are more professional in nature, often vocational such as the DISC profile, the McQuaig and many others. These are called competency assessments. These handle professional and often vocational capabilities and identify and measure capabilities such as patience, vision, speed and so on. Essentially these identify and measure job skills.

The personality and competency assessments and approaches are very good at what they do and measure very well what they set out to measure. The personality assessments provide deep insights into one and the competency assessments provide deep insights into one's job capabilities.

> ***"…..The field of personality is now being supplemented by the linkage with financial outcomes….."***

However the one thing that these assessments do not do is provide any correlation with likely job <u>outcome</u>. They are very good at indicating how a person will perform certain task and how they will approach social and professional situations. But the evidence is in that there is no linkage with job outcome. This is not surprising. These assessments were not designed to look at job outcome per se but instead to reveal what behaviors in relevant areas would be exhibited and to what extent.

Traditional personality and competency assessment s do not identify or measure financial traits, financial impact of behaviors or financial outcome of behaviors. These assessments were not designed to do that and they have no framework which would directly allow them to do this. Their concerns are in other directions, no less relevant or insightful, but simply not for the purpose of looking at the especially financial aspect of behavior.

However behavioral finance sets out to do precisely that. It is focused specifically and purely on **financial behaviors, financial impacts and financial outcomes**. The field of personality is now being supplemented by the linkage with financial outcomes. This in turn is being supplemented by neuroscience whose offshoot, neuro-economics, is specially focused on the physiological aspects of financial decision-making. For the first time behavioral science is studying issues which are of direct interest to compensation strategists because these studies hold out the promise of understanding how to use compensation strategies to influence financial behaviors and outcomes at the level of the individual, not at the level of job function or job level.

. "….These financial traits constitute an internal calculus which drives how each of us approaches decisions involving risk and reward and cost and benefit…."

Behavior finance and economics specifically address the issue of mixed rationality in behavior. They specifically address financial issues.

For the first time we can see emerging models which address the two factors missing from traditional compensation approaches, namely financial behaviors and mixed rationality in decision-making.

Part 2 The Age of Behavioral Finance

Understanding Financial Behaviors is Critical in Compensation Approaches

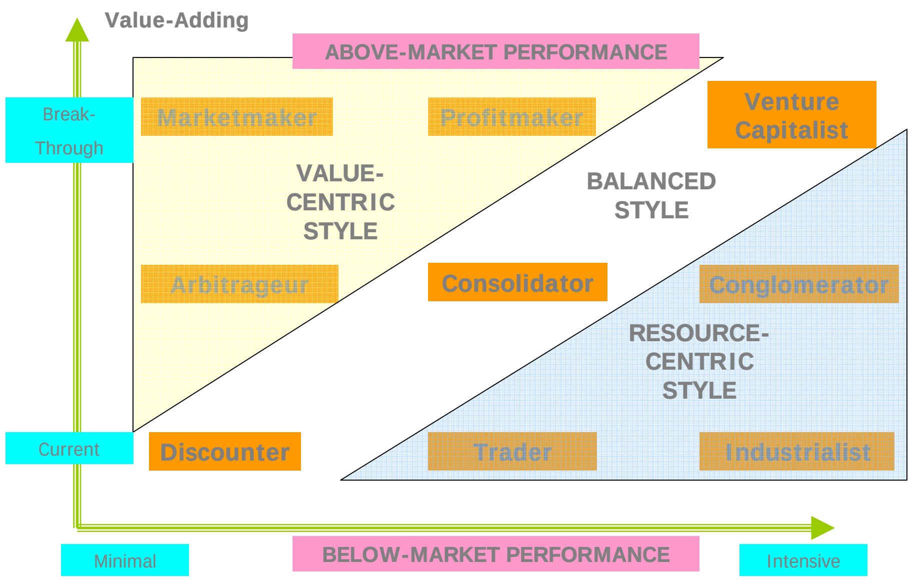
The problem for compensation strategy is how to define what is rational and non-rational and all the states in-between. It then needs to link this to financial performance and shareholder outcomes, the fundamental objective of any compensation strategy. Without such a model, the aim of integrating mixed rationality into compensation strategy is not achievable.

Until now, behavioral finance has focused on the implications at the group level of mixed rationality. But this cannot be applied at the level of the individual; to date behavioral finance models have only been able to focus at the level of the group or crowd. However the Perth Leadership Institute has developed such a model which focuses at the individual level. It had developed a typology of the behavioral financial traits of individuals that is linked directly to financial and valuation outcomes. This provides the necessary framework for compensation strategy to match pay plans to performance outcomes, based on an individual's particular financial behaviors and impacts.

Our research is based on the observation that we all have individual financial traits. These financial traits lie deep within us, so we call them innate. These financial traits constitute an internal calculus which drives how each of us approaches decisions involving risk and reward and cost and benefit. They imprint themselves on all of our decisions, usually without us knowing.

Our research shows there are distinct behavioral patterns which reflect the different ways that individuals are driven by these internal factors to create financial value. These behavior patterns are called *financial signatures*. Our research has identified nine financial signatures which we show below These nine signatures form the basic construct of the model of financial styles that were developed in the course of our research.

Figure 1 The Nine Financial Signatures



These financial signatures are composed of two dimensions of financial traits: the propensity to utilize resources to a greater or lesser degree in achieving business goals, and the propensity to add commercial value to products or services. Together they define the business acumen and financial impact of an individual, that is, an individual's propensity to create capital.

The difference between the nine financial signatures may appear merely to be a question of quantity. However there are qualitative differences between the nine signatures. Each represents a qualitatively different approach to creating commercial value.

These nine different signatures therefore represent different cognitive approaches to value creation. They represent in each case a distinctively different financial personality with vastly different approaches to adding commercial value and using resources.

These cognitive differences will be reflected not just in decisions which are clearly financial in nature but also in decisions which do not appear at first glance to be financial but which have disguised financial implications. For example, even the issue of finding a mate may be regarded as a financial decision since it has benefit (the survivability and success of the likely offspring) and resources (the amount of time and resources expended in finding mates who can bring about the desired benefits) and a return on the investment (the ratio of the benefit to the resources utilized in getting it).

Each financial signature is a personalized and, mostly, partly irrational response to a financial situation which imposes a systematic and predictable bias on all of our financial decisions. Thus individual behavior and individual cognitive effects lead the decision to be at least partly irrational in the particular manner dictated by the particular position that the manager occupies on the diagram in Figure 1.

> ***"….compensation strategy must take into account the different financial behaviors of employees….."***

The resulting financial signature shows us the behavioral propensity of an individual to generate capital to a greater or lesser extent. In Figure 1 The Nine Financial Signatures, financial signatures to the upper left generate more capital, since their propensity to add relatively high amounts of value more than outweighs the resources they are behaviorally inclined to consume in achieving this value. On the other hand, on the right-hand lower side of the diagram, individuals use a level of resources which generally will not be outweighed by the value-added contribution, which generates less than or even the consumption of capital.

It will now have become clear that compensation strategy must take into account the different financial behaviors of employees since these behaviors represent qualitatively different cognitive approaches to employee financial performance. Each of these financial signatures will have different strengths and vulnerabilities.

There task of compensation strategy is to ensure that these different behavioral strengths and vulnerabilities are, respectively, fostered and suppressed by the pay mechanism that are employed. If care is not taken to do this, then the pay mechanisms could well actually foster the vulnerabilities' and suppress the strengths, exactly what is happened in so many cases in the run-up to the present economic crisis.

Measurement of Financial Traits Drives Link to Compensation Strategy

The value-added dimension of financial style of an individual is reflected in the gross margin of a unit or enterprise relative to similar units or close competitors. That is, this accounting measure is a true measure of value-added, both at a corporate and at a behavioral level. We use this measure and not profitability because the latter does not measure value-added. It was not designed to do so, and in any case is too prone to manipulation to be useful.

Similarly, the resource utilization dimension of financial style of an individual is reflected in the level of indirect expenses relative to units doing similar work or close competitors. Once again this must be converted to a percentage of revenue to compare with other units and competitors.

Over time the dominant financial signatures in an organization will be reflected in its financial statements. If there are many leaders and employees with high value-adding signatures, the gross margin of the organization will be high relative to its competitors. If an organization has leaders and employees with low resource utilization their indirect expenses will be low relative to their competitors.

In an organization like this, where gross margin is high and indirect expenses are low, there will be a buildup of capital relative to competitors. In this case, its valuation will rise over time relative to its competitors. Thus we can see that financial signatures will directly impact the market value of a company as shown in its financial statements.

With this approach, we can calculate the financial signature of an individual or even a team and compare it with other employees and teams using behavioral assessment. This will show the relative positions of the employees in a company from the viewpoint of their financial missions. We can then compare the behavioral results with the actual results as shown in the financial statements. This allows us to see the valuation direction of the company and the extent to which the financial culture is shared and aligned with its strategic valuation direction.

Financial signatures represent the most basic level of financial behavior. These can be grouped into styles which aggregate the signatures into a higher level representing the financial impact of these styles.

"…..The goal of compensation strategy is to provide monetary incentives to change their financial mission in a way that will help achieve the organization's objectives….."

We can divide the nine financial signatures into three financial styles based on this diagram: the Value-Centric, Balanced and Resource-Centric styles. The first tends to outperform peers and the last to underperform, while the balanced styles perform at the average level. Thus financial signature and style can tell us not only about the level of individual performance we can expect, but also what will happen if a team or company is composed mainly of a particular financial signature or style relative to its close competitors and to the market it participates in as a whole.

Our research identifies and measures financial signatures and also reveals whether the financial mission is different from the financial signature, and if so, to what extent. Our results show that most people cluster to the lower right of the financial signature chart.

Most managers have financial signatures that lead them to underperform the market and either to generate less capital than their close competitors or to consume it. This pattern prevails even at high executive levels, and so far we have not found a statistical difference in financial signature between executives and other levels.

This parallels work done in other leadership studies which shows that on both personality and competency tests, there are no significant differences between managers at widely different levels it also provides a more scientific underpinning for studies that show few leaders consistently make money and that the vast majority fail as leaders on both straight leadership and financial results grounds.

Financial Signature Reveals the Behavioral Goals of Compensation Strategy

While a financial signature is fixed, the way we express it in actual practice can be changed either if we become aware of it ourselves or through others telling us, or through adopting the financial culture of an organization. We call the expression of the financial signature in practice *the financial mission*.

This is the philosophical basis for using financial signature in compensation strategy. Once a person learns their financial signature they can, in principle, change it, although the extent to which they can do this depends on their learning agility. The goal of compensation strategy is to provide monetary incentives to change their financial mission in a way that will help achieve the organization's objectives.

> ***"….We can see then that the right direction that compensation strategy needs to take this individual towards is defined by their financial style and their financial signature…."***

The Perth model in effect tells us and the individual what zones of financial behaviors feel comfortable to them, and which ones produce discomfort. Zones of comfort in certain areas of behavior will eventually lead to career derailment, performance sub-optimization or even outright failure because the persons experiencing these zones of comfort accept their vulnerabilities which are therefore not addressed. This in turn will lead these employees to deliver less-than-optimal value and capital creation due to these vulnerabilities. This can actually result in excessive capital consumption on behalf of their organization. By revealing these hidden zones, compensation strategists can devise a plan to help them move towards their zones of discomfort so they correct or compensate for the behavioral vulnerabilities that lead them to consume capital in the first place.

Financial signature thus provides a behavioral map for compensation strategy based on behaviors and how they need to be changed in order to meet organizational valuation and financial goals. The nine financial signatures in effect define all the states of rationality ranging from low to high rationality. They show how innate financial behaviors lead to unintended behavioral impacts, ranging from consuming a lot of capital to not being able to create it.

In the Perth model, most individuals naturally consume capital and only a few people create it. For those who naturally create capital, often the need will be to ensure that they do not in effect create too much, running amok so to speak and creating and hoarding cash when a better decision given organizational strategy might have been to put it to good use (such as market expansion and sales growth).

But for the vast majority of individuals, the reverse will be the case. They will consume capital either because they tend to use high levels of resources, or create little commercial value-added, or some combination of the two.

The goal of compensation strategy in this case is to nudge or push them in the direction of creating capital by leveraging behavioral, organizational and process techniques that will help them move in the right direction and then rewarding them for these moves through compensation. Thus compensation strategy is now able to distinguish the individual financial behavioral needs and vulnerabilities of employees within a given job or functional classification for the first time.

We can see then that the right direction that compensation strategy needs to take this individual towards is defined by their financial style and their financial signature. Each of these will require different combinations of techniques based on where they are located in the financial signature chart. The goal of compensation strategy is therefore to provide a compensation plan that will move their behaviors in the desired direction but utilizing the appropriate combinations of pay plans that will achieve the desired behavioral goals and financial impacts.

In doing this we can thus avoid the behavioral traps that affect traditional compensation plans producing perverse compensation incentives. The most widely known of such perverse effects is rewarding salespeople for getting more sales that are unprofitable. Salespeople who have a behavioral propensity to create capital can safely be given revenue-based commissions but those who consume capital should have compensation programs which are focused at least in part on incentives for capital creation, such as gross margin or contribution-based compensation.

This is not to say that traditional compensation strategies do not work or should not be used. Providing behaviorally-based compensation plans fills a major gap in the pantheon of techniques available to the compensation strategist and designer. It expands the range of tools and levers that the strategist can use to make compensation more effective.

We are not advocating that only behaviorally based approaches should be used by compensation strategy. But we are saying that they must be integrated into compensation strategy to complement the current job and functionally-based techniques which currently avoid behavioral issues and thus compromise the effectiveness of compensation strategy.

Part 3 Moving Forward

Compensation Plans for High-Impact Players Must Adopt a Behavioral Focus

The objectives of a behaviorally-integrated compensation plan (BCP) are:

1. To improve the effectiveness of a compensation plan over and above one that is based purely on functional and job categories
2. To apply it to individuals or teams whose impact is particularly important or financially impactful
3. To provide it as part of an integrated development and performance management plan for certain high-impact employees

Behaviorally-supplemented compensation strategies address a fundamental problem in the field but they also have one additional step; it is necessary to conduct a behavioral assessment as part of the strategy. For most companies this limits their applicability to more senior managers, high potentials and P&L managers at all levels and to particular sub-groups e.g. effective salespeople who do not produce profitable results. The need is for the participant to complete one or two short assessments that provide the behavioral information needed to develop a customized compensation plan for them.

BCPs will cost more money. However they are there to radically improve the performance of the more important players and particular groups by improving the effectiveness of the compensation by using behavioral targeting. They should be regarded as an additional step to radically improve the match between compensation strategy and financial and shareholder performance. Thus they represent a new way for compensation specialists to improve their impact on financial, valuation and shareholder outcomes.

"…..Behaviorally-supplemented compensation strategies address a fundamental problem in the field but they also have one additional step; it is necessary to conduct a behavioral assessment as part of the strategy……"

The role we are suggesting here reflects a major transition for compensation practitioners. It moves them from being perceived as technical specialists to strategic talent management consultants who use behavioral finance techniques to further help improve the match between strategy and execution in a firm. We believe that this is a major need in the area of compensation, to take it from what is usually regarded as primarily an actuarial to a strategic orientation.

Implementing Behaviorally-Targeted Compensation Plans

Implementing these behaviorally-targeted compensation plans requires somewhat more of an intensive approach because behavioral data needs to be obtained as part of the process. The main changes to traditional programs are as follows:

- **Assessments**: Each high-impact employee for whom a behaviorally-targeted compensation plan is being designed needs to take two assessments. These are short and online so the effort is not excessive. However the framework around the compensation plan needs to be explained in advance to the employee. This includes not only the front-tend of the process, namely assessment and compensation design, but also the back-end, that is the evaluation and re-assessment component and how it will be carried out. <u>If the compensation plan is also going to be integrated into a development plan (see the section below) then the linkages will also need to be explained including the possibility of coaching and again the evaluation component.</u>
- **Training for practitioners**: The compensation plan designer could be an external consultant or an internal employee from HR. In either case they need to be trained in this new approach. In many cases they may not have the requisite capabilities to conduct a behavioral program and it is possible that new practitioners with behavioral training are also used to deliver the program. Since there is a different paradigm involved, i.e. there is a shift from an actuarial to a behavioral focus (which however does not exclude one or the other), the need for different training materials and a different framework must also be considered.
- **Training for employees**: Employees undergoing this program may also need briefing and some training. Again this will particularly be the case if the compensation program is integrated into a development plan.
- **Employee communications**: Generally, if a program such as this is introduced, there may need to be a wider effort at communicating this to employees generally together with the benefits so that it is not seen as intrusive or invasive.

Most compensation strategies are based on an approach such as the following:

1. Development of <u>organizational objectives</u>.
2. Development of <u>employee performance metrics</u> which map to the achievement of these objectives.
3. Development of <u>position descriptions</u> which map to these objectives together with required performance metrics at the job level.
4. Use of <u>survey data</u> to find comparables
5. Developing an <u>evaluation metric</u> an and performance appraisal system based on the performance metrics
6. Integrating <u>salary administration</u> with the evaluation system.

7. A <u>communications</u> strategy for employees covered by the compensation plan to tell them how it is working

A BCP will change them in the following ways as follows:

1. Development of <u>organizational objectives</u>.
2. Development of <u>employee performance metrics</u> which map to the achievement of these objectives.
3. **<u>Development of guidelines for ideal financial signature and mission which helps achieve organizational goals to which employees should be guided</u>**
4. Development of <u>position descriptions</u> which map to these objectives together with required performance metrics at the job level.
5. **<u>Development of performance metrics which can be used to measure change in behavioral financial mission of the individual</u>**
6. Try to find comparables even if they do not include formal behavioral data.
7. Developing an <u>evaluation metric</u> an and performance appraisal system based on the performance metrics
8. **Developing an <u>evaluation metric</u> an and performance appraisal system based on the financial style metrics**
9. Integrating <u>salary administration</u> with the evaluation system.
10. A <u>communications</u> strategy for employees covered by the BCP to tell them how it is working in their particular place
11. **<u>Re-assessment of the BCP to improve its effectiveness based on the employee's performance.</u>**

Since the impact of financial signatures can be measured quantitatively using financial statements and metrics, arrangement should be made for these measurements to be followed and evaluated in conjunction with the employee. At this stage we now meet the fundamental issue of whether the company will try to go one step further, that is, integrating performance and development. This is a philosophical change and paradigm shift of great importance, as we will discuss in the next section.

The Holy Grail - Linking Performance with Development

There have been two great themes in the management and development of talent aimed at maximizing its performance. These two themes are:

- Performance management
- Talent development

These two themes are the underlying drivers of talent management as an overall activity.

Performance management has traditionally been approached via compensation. The aim has been to maximize performance; however it is defined, through compensation strategy and mechanism. The performance management process is enshrined in activities including the following:

- Performance objectives
- Performance metrics
- Job descriptions
- Compensation design
- Pay mechanism
- Performance appraisals

Almost all companies incorporate these into their HR processes. They are basic to all HR activities in almost all companies.

Talent development: This has usually been approached via training and coaching, both internal and external. The training covers a variety of activities ranging from social and cultural topics such as sexual harassment and diversity training though to executive development which focuses especially on social and interpersonal interactions. Some of the activities here include:

- Executive assessments
- Management training
- Steady development
- Managing conflict
- Financial literacy
- Execution and operations
- Coaching

The Great Divide: However these two great strands have rarely intersected and are usually conducted as totally separate activities. Compensation is almost always separated organizationally from development. When performance fails to meet goals as set out in the compensation strategy this is rarely followed up through development. Furthermore, when development aims to achieve certain objectives at the group or individual level, this is rarely designed into compensations objectives and pay plans.

Much of the problem has its roots in the absence of a framework that would integrate performance management and talent development. It is hard to see how performance can be improved through development activities such as diversity training since there has been no set of metrics that would show the direct financial impact of not doing it, for example. And while compensation plans may link performance directly to metrics such as profitability, there has been no framework to show how management development activities would directly impact those financial metrics.

"…..Compensation is almost always separated organizationally from development….."

The lack of such a framework has the effect of reducing the effectiveness of both performance management and development carried out in isolation from each other. The lack of such a framework has encouraged performance management and compensation specialists to carry out their work in isolation from development and training professionals.

As the senior partner in this dyad, employing far more people and using far more resources that on the talent development side, the performance management side has more potential influence in bringing the two sides together. However the actuarial and technical nature of performance management activities has restrained this movement and exacerbated the divide.

The divide is represented by the technical people on the performance management side and the behavioral people on the other. There has been a longstanding and lingering distrust of each other from both sides based on different philosophical approaches of each, their different educational backgrounds and qualifications and the different mindset each brings to its side of the equation. Without a rapprochement of sorts between the two sides, both will suffer and be unable to achieve their true potential. As long as this divide exists, compensation strategy cannot advance past its current limitations. It goes without saying that the same is true for the talent development side.

Our thesis is that it is precisely **<u>the great divide between development and performance that is the root of the problems in compensation strategy that are linked to excesses in economic crises</u>** such as the one we are experiencing now. As long as compensation strategy is not linked to behavior, it has no way of predicting when pay plans will lead to perverse outcomes, such as happened over the past decade. And if development cannot link its activities with financial performance it has no way of developing organizations where development activities will result in increased performance, the main charge against training organizations in most companies.

Until this divide is bridged the lack of a behavioral focus in performance management programs will result in systemic excesses and the lack of performance metrics in development will lead to subpar performance. Furthermore we will tend to get periodic and grandiose oscillations between the two.

In boom times, the compensation specialists and performance management side will be in the ascendant since everything seems to be working well. Once the bubble bursts the performance management and compensation specialists lose credibility and the development people take over. However their lack of familiarity with the performance side will result in less performance. Eventually the pendulum will swing back to the performance side, excesses will inevitably result, and the bubble will arrive and burst yet again.

And, of course, our thesis is also that a framework such as the financial signature model is an example of a framework that can allow this synthesis to occur. By linking behaviors directly with financial outcomes it allows the developmental behaviorists to see direct links between development and performance. And for the compensation side, it allows them to design pay plans which have direct links to behavioral financial outcomes and showing how to change behaviors in ways that improves these outcomes while also avoiding perverse and unintended effects and adverse behavioral outcomes.

Behavioral finance at the level of the individual provides the framework to bring these two schools of thought together for the first time. This will result in the next major leap in the effectiveness of human capital disciplines and approaches.

The Great Divide thus has macroeconomic and global implications, not just implications at the firm level. The Holy Grail is to unite the two. Bridging this great divide will not only result in compensation strategy moving to a new level of performance, but will also solve fundamental problems in the national and global economy. Bridging the two is no less than behavioral financial engineering on a large scale moving up from the small.

Recommendations

What an organization will do in this area depends on its mood and objectives. Steps can be as small as gradually integrating behavioral training for compensation specialists in behavioral finance approaches right up to integrating performance and development approaches. This will depend of a variety of factors in the organization including:

1. The extent to which the organization really wants to influence heavily high-impact players in their financial impact and performance
2. Whether it is more or less concerned about sustained versus short-term impact
3. The degree of resistance to change amongst both the companion and development organizations

So there are a number of steps an organization can take depending on its appetite for change and its desire to make its compensation strategies part of a broader talent management thrust. Taking them in this order, we can recommend the following steps:

1. **Take steps to recognize the role of behavior in compensation strategy**
2. **Start training compensation specialists and consultants in behavioral finance and its implications for compensation strategy**
3. **Draft a behaviorally based compensation approach for high-impact players**
4. **Introduce behaviorally based compensation strategies for them**
5. **Recognize the phenomenon of financial derailment and take steps to address it through compensation strategy**
6. **Recognize the compulsion of operating in a comfort zone and the role of compensation taking them out of it**
7. **Start to integrate compensation and development organizations**
8. **Integrate performance management and talent development strategies**