

New Fed Compensation Rules Still Don't Get It?

A Blunter Instrument?

The Federal Government has now finally implemented its new compensation guidelines via its new pay Czar. Already numerous companies are implementing many of these principles in their own plans. These include Polo Ralph Lauren, Sysco, Eli Lilly and Ingersoll-Rand just to name a few. What do these moves mean for the future of compensation strategy in organizations? How can we use these rules to make compensation systems better and even more aligned with corporate objectives?



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First, what are the major changes that these companies are making as influenced by the new approach to compensation? They include:

- More emphasis on stock-based compensation
- Longer-term holding of stock and other compensation instruments to aid in longer-term alignment of employees with company interests
- Higher performance hurdles for bonuses
- Limits on perks, severance and supplemental pensions

The new Federal approach may be seen as necessary but in many ways it is a very blunt instrument. After all, the main purpose of compensation is to align employee interests with the interests of the organization that employs them. Limiting compensation may not necessarily do this. The issue is how to increase alignment, which may actually mean increasing compensation, and at the same time limit risk? This is the \$64 question.

What About Behavior?

Limiting risk is usually seen as limiting market risk, the chance that an employee will do something which will lead to a negative outcome for the company. But there is another issue which has still not been focused on. This is the issue of behavioral risk.

Behavioral risk is the risk that the behavior of an employee will be such as to lead to negative outcomes. So far the focus has been on lowering the compensation to compensate for a negative outcome actually occurring. The correct approach should be to focus on behavior in the first place so that compensation strategy actually lowers the behavioral risk that leads to negative market events and outcomes. But the new Federal approach does not do that.

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Does Compensation Strategy Have a Future?

We published a White paper on precisely this topic in April of 2009 - **[Compensation Strategy and Economic Crises: Time for a Radical Rethink](http://www.perthleadership.org/documents/WPCompensation4_09Final.pdf)** see http://www.perthleadership.org/documents/WPCompensation4_09Final.pdf . We focused on how compensation strategy has evolved until now and what it needs to do in the future in order to remain relevant to the new age of corporate responsibility and given the need to reduce behaviors that lead to economic crises. Some of the key points we made were:

- In order to limit risk you need to understand the behavioral drivers of employees at some level
- Limiting compensation does not address behavioral issue in risk in and of itself
- In the long run you cannot contain behavioral risk unless you somehow link performance management and compensation with talent development
- Organizationally this requires bridging the great divide between executive development, compensation and performance management

Our thesis was, and still is, that unless this is done, the type of economic event we have just gone through will occur again since fundamentally, they derive from uncontained behavioral risks that are either partly driven by compensation strategy, or from compensation strategies that are not designed to avoid these behaviors, thus leading to negative market outcomes.

The Technical Fix Doesn't Fix It

In analyzing the history of compensation strategy, our White paper argued that compensation strategy has evolved as a technical discipline. It has signally lacked a behavioral focus. 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.

"....The most impactful and innovative move is to integrate performance management with talent development...."

Our White paper argued that the emergence of a new discipline of behavioral finance has changed the name of the game. Behavioral finance assumes that people do not always act rationally, even if their compensation framework assumes it will.

But the compensation profession has not caught up with this discipline and its implications yet. If they don't, sooner or later they will become irrelevant.

New Model of Financial Behavior Needed – If Not Wanted...

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.

We argued that behavioral approaches work best 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.

Business Acumen Reflects Behavioral Risk

Our argument is that compensation strategy and models need to take into account the level of business acumen of employees most involved in the decision-making processes that lead to negative outcomes. The level of business acumen of an employee is actually also a proxy for their level of behavioral risk.

Employees with low business acumen tend to be more likely to have more negative outcomes and those with high business acumen with more positive outcomes. Of course we also need to take into account their ethical attitudes too.

But if we can get a handle on this and also show the employee how to understand their level of business acumen we are already well on the way to improving business behaviors and lowering the level of systemic risk as well as the level of behavioral risk with an individual employee.

Financial Signature and Behavioral Risk

In the case of the Perth Leadership Institute, our business acumen approaches focus on what we call the financial signature of an individual and the level of risk that this might entail. This financial signature and

the corresponding level of risk can be assessed and measured using our assessments.

But in principle any method that does the same thing will achieve the same end. The requirement is for a psychometric assessment of behavioral risk that links directly with financial outcomes.

We can see then that the right direction that compensation strategy needs to take the 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.

We argued in our White paper that 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.

The Great Divide

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 since there has been no set of metrics that would show the direct financial impact of not doing it. 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.

Our thesis is that it is precisely **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** 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.

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So what can HR and executive development professionals do to achieve these objectives so as to reduce overall behavioral risk and increase alignment between employee and company goals? We argued that they need to do the following:

- 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. Introduce a behaviorally based compensation approach for high-impact players**
- 4. Start to integrate compensation and development organizations.**
- 5. Integrate performance management and talent development strategies**

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