FOUR REASONS TO CHANGE HOW YOU APPROACH PERFORMANCE RATINGS

Rewarding performance can seem like such a simple thing. Give more money to the top performers versus the lower performers. Unfortunately, real life isn't that simple. Compensation practices can become complicated in what is measured, how things are paid out, and, ultimately, what is rewarded. Worst of all, compensation practices can often have unintended consequences, as they can drive undesirable behaviors.

For example, a sales bonus is a very common compensation tool that companies use to reward their salespeople's' behaviors. But as an HR leader with over a decade supporting commercial organizations, the one thing I've learned is that salespeople very quickly learn how to game the system. I've seen salespeople give away highly profitable service contracts in order to win a low margin sales deal. I've seen salespeople pressure their customers to pull forward their upcoming year's orders into November/December, so the salesperson would hit their end of year targets. In both of these examples, salespeople were compensated through their sales bonus to make these kinds of decisions, even though both arguably hindered the company's success.

The sad truth is that rewarding performance is a hell of a lot more complicated than we want to admit. We already know that identifying the right behaviors that we want to reward is tough. I wrote multiple articles just covering that topic alone. But even if we have identified the critical behaviors we want to reward, we can still screw it up by using the wrong compensation tools (or using them in the wrong way).

That is why we started a four-part series on Performance Management Fundamentals, and how your bank can unlock the performance of your people. In previous months' articles, we discussed why banks should empower their people to determine their own goals, use frequent one on one meetings to coach the performance of their people, and modify how they measure performance. But, obviously, those three articles were just setting the stage for this month's article, how we can reward the right types of performance in our people.

Four Most Common Ways to Reward Performance

There are many different ways to reward performance, but for the most part, companies use some mixture of the following four compensation tools:

<u>**Base Pay/Merit Increases**</u>

- **Definition** - Most companies review the salary levels of their people every year, with a few companies doing it every six months. As most roles lack quantifiable performance metrics, merit increases are often connected to performance ratings. The people with the top performance ratings will receive the largest salary increase, while people with the bottom performance ratings will receive a minimal increase (or nothing at all).

- **Critical Issues to Consider**

    - Permanent Cost Increases - Merit increases are permanent changes to their base salary (which means a permanent change to your cost structure). Once they get a salary increase, you can never take it away, even if their performance decreases.

    - Long Term vs Short Term - An increase to your salary should be rewarding you delivering your objectives in a manner that is aligned with the culture and long-term strategy of the company. A merit increase is a permanent change to their salary, and it isn't enough to just reward a person's results. If you do, then you will drive short term mindedness.

    - Fairness/Equality - Are you paying people similar amounts for similar levels of performance in similar jobs? If not, then you should be using some of your merit budget to help address some inequality issues.

- Inflation - If your merit increase budget isn't above inflation, then in a weird way you are actually decreasing your people's salaries. I remember some of my colleagues in Asian countries would get an 8% yearly salary increase, and while that seemed large at the time, they lived in a country with 10% inflation. When inflation is not factored into merit budgets, people will start looking outside just to maintain their current quality of life.

- Motivation - There is a good deal of research that shows increases in salary have no lasting impact on engagement or motivation. It isn't as simple as more money translating into higher performance. That being said, too low of a salary can be demotivating, and this connects back to perceptions of fairness and equality. If you are being paid 75, while everyone else is being paid 100, you will probably be disengaged and unmotivated too.

- **Recommended Usage** - As explained above, merit increases need to do too many things at once (reward short and long-term behaviors, fix inequality issues, address inflation, etc.), and only have a limited impact on motivation and performance. For those reasons, we consider merit increases to be a hygiene tool when it comes to rewarding performance. Yes, your company should use it, and yes, your company should connect it to your critical behaviors. But ultimately, you need to leverage the other tools to truly drive performance.

Bonuses/Variable Compensation

- **Definition** - Bonuses (also known as variable compensation) are a yearly reward where different amounts of money are paid out depending on specific performance metrics. These bonuses are either built using overall company metrics, individual performance metrics, or some mixture of the two. Over 70% of companies use a bonus structure, although most of them are limited to commercial roles or senior leadership roles. These bonuses are different from the One Time/Recognition Bonuses, as they are an agreed part of the employee's compensation package.

- **Critical Issues to Consider**

  - What vs How - The majority of bonuses solely focus on performance metrics to determine payout. Did the salesperson meet their revenue targets? Did the business unit hit its operating income targets? This is a mistake. If your company doesn't tie your bonuses to your culture, then you are just incentivizing people to deliver results at whatever the cost.

  - Short vs Long Term - Similarly to including culture in bonus calculations, you need to make sure that you are not biasing your bonus metrics to your short-term strategy. Bonuses are great at motivating people; therefore, you need to include some long-term metrics into the bonus calculation. If that is not possible, then you should at least review your bonus metrics to see if there are ways that your people will 'game' the system in order to get a bigger payout.

  - Non-Quantifiable Metrics - Finally, the majority of bonuses focus on quantifiable metrics (i.e., revenue, profit, sales calls, etc.). This makes calculating bonuses easier and more transparent for people. The problems arise when we want to bring in metrics that are not easily quantifiable (i.e., role modeling the culture, building organizational capabilities, etc.). Your bonus plan needs to be able to handle both types of metrics, and how the bonuses are calculated should be transparent. A bonus isn't motivating if your people don't understand what behaviors / results are rewarded.

- **Recommended Usage** - Yearly bonuses are a great tool and are amazing at driving very specific behaviors. But that's the trick, if you don't map your bonus criteria to very specific behaviors, then most likely you are going to be motivating the wrong behaviors. For that reason, I actually recommend that a significant effort is put into your bonus scheme, and ideally extending that bonus scheme for all employees. By expanding it to everyone, you are giving a clear message that the company's success is something that they can share, assuming they perform.

One Time/Recognition Bonuses

- **Definition** - Unlike yearly bonuses, One Time / Recognition bonuses can occur throughout the year. These special one-time payouts are meant to highlight a specific accomplishment of the person.

- **Critical Issues to Consider**

  - Rewarding Above and Beyond - While yearly bonuses are great for rewarding expected performance, Recognition bonuses are perfect for rewarding an accomplishment that goes above and beyond the norm. Maybe they successfully launched a product early or closed a giant account unexpectedly. Ultimately, the recognition bonus should only be given to things that actually merit the extra attention.

  - Rarity vs Frequency - Even though the Recognition bonus should only go to special accomplishments, you don't want to make the threshold too impossible. If Recognition bonuses are too rare, then they will not motivate your people. You want to find a sweet spot where Recognition bonuses are given for performing above expectations, but everyone feels like they too could earn a Recognition bonus.

  - Culture - Make sure your criteria for your Recognition bonus includes your culture. If you only reward results, then there is a risk your people will deliver results at the sacrifice of your culture.

  - Communication - Every Recognition bonus you award should be communicated to the company. I am not saying you need to share monetary amounts, but you should share why the person is receiving the bonus. By sharing the criteria for which you gave the bonus, you are clearly communicating the exact behaviors you want to reward in your company.

- **Recommended Usage -** Recognition bonuses are great and should be used much more frequently than they are. I especially love using Recognition bonuses to highlight Cultural achievements, even a big swing and a miss. Imagine this scenario, let's say your Culture is built around innovative ideas that are focused on your users. You have an employee that put together a really innovative solution for that customer, but that customer didn't buy it because of external factors. Even in that situation, I still might do a small Recognition bonus for that employee. Failing shouldn't always be punished. In fact, if they fail while doing the right things, they should be rewarded.

Stock/Equity Grants

- **Definition** - Finally, we get to one of the most intriguing and rare compensation tools, rewarding performance through stock in the company. There are many different ways to use stock / equity in your compensation practices (initial stock grants, restricted stock options, etc.). I am not going to pretend that I am the legal expert on how your company can setup a stock compensation program. You can find a great starting resource here.

- **Critical Issues to Consider**

  - Long Term Criteria - Your stock/equity program should be built around the short and long-term success of your company. The highest grant amounts should only be given to the people that have delivered the best results in a way that is best aligned with the culture of the company and the long-term strategy. I also prefer to use the Growth performance metric in stock programs as well, as we should be rewarding people that are actively preparing themselves to succeed in tomorrow's world.

- Shared Ownership - One of the best aspects of a stock/equity program is that it fosters an ownership mindset. Quite literally, your employees become part owners of the company. And that shared ownership drives higher levels of engagement and a willingness to think about the good of the company.

- Retention - Stock programs are by their nature focused on the long-term success of the company. This is reinforced due to the fact that the stocks are not given all in one lump sum, but rather they are given over the course of multiple years. If the person leaves the company, then their remaining unvested stocks disappear. This provides a natural retention incentive, as people will have a hard time walking away from their unvested stocks.

- Payouts - Some companies are already publicly traded companies, or in the process of an IPO (or pre- IPO). In those situations, stocks have a set value, and people can easily convert their stocks to cash. But if your company is private, then any stocks granted to your people will not have an easily convertible value. For those companies, it is critical to think of different options on how to either buyout people’s stock or provide value based on the stock (i.e., dividends).

- **Recommended Usage -** I personally think every company should consider an employee stock program, especially for those companies already publicly listed. There are just too many benefits to ignore. And for those companies that are private, you should investigate if there is a way to make your stocks valuable. People perform better when they feel like they own the success of their company.

Less Common Ways to Reward Performance

While salary increases, bonuses, and equity programs are the most common way to reward performance, they are not the only ways. Here are a few different methods you should consider using for your bank.

- Extra Benefits - Money is not the only type of compensation that your people receive for working. They also receive corporate benefits, for example health care plans, free lunches, and vacation days. Some (not all) of those types of benefits can be given as ways to reward performance. For example, imagine that you have a team that has put in extra-long hours for a month trying to land a critical project. One way to reward their effort and performance is to give them extra vacation days.

- Professional Development - Investing in the person is another great way to reward their performance. Maybe you pay for them to join an external conference, or to gain a professional credential they’ve been wanting. I personally love this type of reward, because it has wonderful long-term effects. Not only are they recognized for their performance, but their overall performance will go up as a result of their growth.

- New Opportunities - Similar to professional development, sometimes a way to recognize someone's performance is to give them an opportunity to gain new experiences. Maybe they believe running a companywide project would help their career or working with a different type of customer will lead to a promotion. This type of reward is even better than professional development, because it has the same impact on the person, but the cost is even less for the business.

It's All About Measuring and Rewarding Performance

Rewarding performance is all about motivating the right behaviors. While it may not feel like it, part of the human brain works just like a mouse receiving cheese for pushing a button. Our brains are hardwired to perform behaviors that are positively reinforced and avoid behaviors that are negatively reinforced. If you need an example, just think about children. Either you have children, or you were a child. But no matter what, you have seen first-hand that kids are motivated through positive reinforcement and rewards.

That doesn't mean you need to start treating your people as if they were toddlers (although I have had to coach my fair share of childish leaders). What we need to do is be very clear on what behaviors we are trying to reinforce in our people. And once we know those behaviors, aligning a performance management process to assess and reward those behaviors is simple. That's the honest truth. It really doesn't matter what performance system or process you use. If you measure and reward the wrong behaviors, your bank will not reach the highest levels of success.

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