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Automating Incentive Plan Management: Less Excel, Higher Productivity, Better Outcomes

Prepared for:

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EXECUTIVE SUMMARY

Automating Incentive Plan Management: Less Excel, More Plans, Better Outcomes, commissioned by IBM and produced by Aite Group, explores the challenges banks face in managing their compensation plans, how these challenges can be overcome with automation, and the resulting benefits.

Key takeaways from the study include the following:

- Salaries and benefits are a significant burden for banks. These costs place significant downward pressure on banks' expense ratios and were twice as high as banks' loss provisions in 2011, according to the FDIC.
- Bank departments face significant hurdles in cost-effectively creating, managing, and administering their incentive compensation plans. Some of the challenges include pay-rule complexity, programming costs, and a proliferation of plans across the enterprise. Plan design is further complicated by a bank's regulatory mandates, strategic objectives, and the cultural issues within autonomously operating lines of business and acquisitions.
- Incentive compensation plan management systems have features and functionality that can make banks' plan management more cost effective. These include plan design, plan administration, reporting, and analysis.
- Banks stand to achieve significant benefits from automated incentive compensation plan management. Some of these benefits include reduced error-driven overcompensation, improved productivity for participants and compensation staff, enhanced brand protection, improved plan effectiveness, and tighter alignment between compensation plans and a bank's strategic objectives.

INTRODUCTION

Outside of the core banking activities of gathering deposits, booking loans, and managing risks, one of the most important things bank managers do is effectively motivate and manage their employees. This is no small task. Bankers, like the institutions that employ them, face a variety of sometimes conflicting motivators when prioritizing their goals and planning their tasks. Credit risk management is the source of one such trade-off. Although responsible for booking new loans in order to generate returns on capital, bankers must also maximize returns by avoiding borrowers that deteriorate in credit quality and incur losses. Regulations, which have become more pervasive and onerous since the global financial crisis of 2008, also complicate banks' ability to offer financial incentives to their employees. Although banks need to maximize the number and value of the financial instruments sold by their employees, the marketing of financial assets—if too aggressive—can invoke the ire of regulators that can both levy fines and generate bad press for banks thought to be selling inappropriate investments to consumers. Motivating employees is also complicated by cultural and strategic considerations. Although incentive plans are typically crafted centrally by a bank's compensation department, such plans must have sufficient granularity to accommodate the individual cultures and levels of entrepreneurialism within a bank's various lines of business and acquisitions.

It is within the context of banks' need to motivate employees while achieving a variety of objectives that Aite Group has examined compensation plan management systems. By identifying both the challenges faced by bank compensation departments and the benefits of automation, this report can be used by banking leaders seeking to make their programs more productive and cost effective. Furthermore, this report can also be used as a tool for those seeking to craft or evaluate a business case for the adoption of an incentive compensation plan management system for the banking enterprise.

METHODOLOGY

This paper is based on in-depth interviews with users of compensation plan management systems at three banks, each with assets greater than US$50 billion. The report is also based on the author's in-depth knowledge of banks and their use of technology, which is the result of a 13-year career in commercial banking and nine years' analysis of enterprise applications, including a focus on the quantification of benefits from software deployments.

BANKER COMPENSATION—HARDER THAN IT LOOKS

Although banks are primarily in the business of gathering deposits, booking loans, and managing risk, one of a bank's most important goals is to build a skilled workforce and maximize its returns on its employees. Adding to the significance of this goal is the average level of banks' compensation costs. Aite Group's recent analysis of FDIC data indicates that as of 2011, the latest date for which data was available, lending institutions' personnel and compensation costs were significant relative to both losses and noninterest expenses (Table A.)

Table A: Compensation Costs Are a Significant Burden for Lenders

Key cost measures as a percentage of average assets	Community banks	Noncommunity banks
Loss provision	0.60%	0.60%
Noninterest expense	3.10%	2.90%
Salaries and employee benefits expenses	1.50%	1.20%

Source: FDIC Community Banking Study 2012

Despite the magnitude and importance of banks' personnel and cost imperatives, managing incentive compensation costs and motivating bank employees have significant hurdles. Among these challenges are the following:

- **Rules complexity**: For any given incentive plan, the number of variables that determine a participant's compensation can become extremely high. Such factors include a participant's seniority, the number of favorable outcomes achieved, the number of unfavorable outcomes caused, the types of products sold, and revenue generated. The more variables incorporated in a plan, the harder it is to deploy—especially in disparate Excel- or Access-based environments—and the more labor intensive the plan is, the higher the error rate will be.

- **Plan proliferation**: With so many lines of business, acquisitions, products, distribution channels, and employee roles, the number of incentive plans that a bank has in place can number in the dozens for a small or regional bank and in the hundreds for super-regional and Tier-1 banks.

- **Data distrust**: While not every employee examines his or her incentive compensation statements with intense granularity, such tracking is typically completed by a significant portion of a bank's plan participants. In fact, many plan participants maintain their own compensation tracking documents that they use to double check their compensation departments' calculations. The more complex a plan is, the more likely employees are to maintain these productivity-draining shadow accounting systems, and the more compensation department productivity will be diverted to corrections and inquiries.

- **Regulatory mandates**: New regulations impacting employee compensation and incentives include the Federal Reserve Guidelines on Incentive Compensation and the Dodd-Frank Wall Street Reform and Consumer Protection Act. These regulations require that a bank designs its incentive plan to ensure that its compensation is not excessive, does not promote the sale to consumers of risky financial assets, and does not promote the booking of risky exposures onto the bank's balance sheet. These regulations also require banks to govern, monitor, audit, and report on their incentive plans with a higher level of detail than ever before.
- **Plan evaluation**: Although banks dedicate significant planning, programming, and administrative resources to their incentive plans, these institutions rarely know how effective their plans are. This lack of knowledge is typically driven by an inability to identify the metrics that can be indicators of success. In the absence of hard numbers or facts about the results of their incentive plans, banks typically rely on the gut feelings and intuitions of their compensation staff and line-of-business managers.
- **Disincentive management**: Banks are relatively skilled at rewarding employees for desired behavior such as cross-selling or up-selling, but these institutions are less adept at motivating employees to avoid undesired behaviors and their outcomes. Undesired behaviors, such as selling an individual financial instruments inappropriate for their risk profile, are typically hard to define and monitor. In financial institutions, lags between seemingly benign activities and their adverse outcomes can also present a challenge. Lending, both commercial and retail, typifies this challenge. Although it's a relatively simple matter to reward a banker for booking a new loan, it's far harder to reduce a banker's pay should a loan cause a charge off several years after it is booked.
- **Incentive plan conflict**: Plan design can be complicated by conflicting goals and objectives within an organization. Although a given line of business may have a simple set of desired outcomes to build into a given plan, its bank's culture, strategy, and regulatory demands can each add objectives that are complicating at best and conflicting at worst.
- **Programming costs**: Homegrown incentive compensation administrative tools are typically based in legacy mainframe systems and or combined with Microsoft Excel, Microsoft Access databases, or SQL. Although these systems may enable compensation departments to build some automation and reporting into their plans, compensation departments typically have limited access to professionals skilled in these areas, and they typically require resources from overburdened IT departments that have far higher average fully loaded annual costs than compensation professionals. Often unfamiliar with the complexities of incentive management, IT staff typically rely heavily on compensation staff as internal consultants, who then become further diverted from their core job responsibilities.

COMPENSATION PLAN MANAGEMENT SYSTEMS

In an effort to evaluate for banks the capabilities and benefits of compensation plan management systems, Aite Group examined one such capability: IBM Cognos Incentive Compensation Management (IBM Cognos ICM). In both examining the system and talking with banks that have deployed it, Aite Group determined that such systems can serve as a calculation engine, data source, workflow management tool, and reporting system for both compensation departments and plan participants. Among the tasks and processes that can be completed by such a system are:

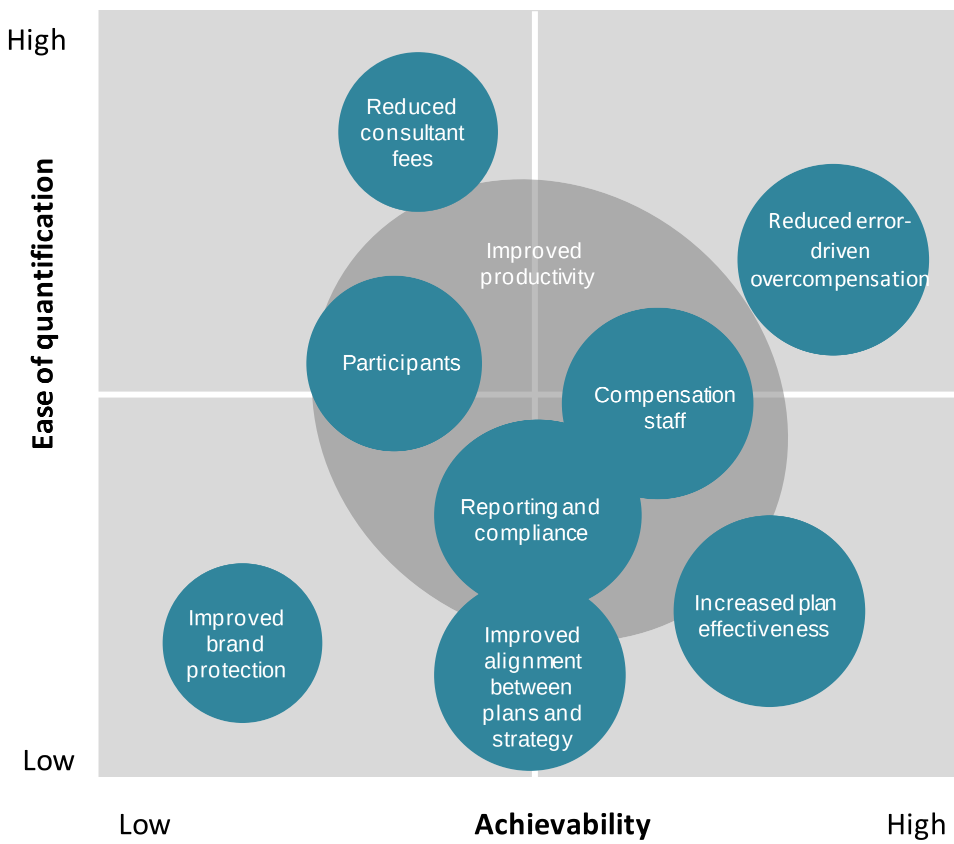
- **Plan design**: Based on their bank's various opportunities, competitive environment, product offering, and sales strategy, compensation managers can craft individual compensation plans, including highly configured incentives, measures and goals, pay rules, and sales-coverage models. Compensation plan managers can also create budgets on a plan-by-plan basis.
- **Plan administration**: Once designed, plans can be configured with quotas, hierarchies, territory definitions, and pay rules for crediting based on participant activities. Administration capabilities also include human resources (HR)-related functions such as quota setting and the distribution of plan details to participants.
- **Compensation administration**: Once plans have been fully configured, compensation plan management systems perform compensation calculations and payroll administration tasks, administer payments to participants, and provide participant-facing tools for inquiries, dispute resolution, and adjustments.
- **Reporting and analysis**: Reporting for deployed plans includes comparisons of plan results relative to objectives, cash flow forecasting, and analyses of plans' impacts on overall bank earnings. Reporting and analysis tools also include audit trails for documenting all changes to plans and participant payments.

Aite Group identified three primary end users impacted by the deployment of a compensation plan management system. Participants can use such a system to understand their compensation, set their goals, and plan their activities. Line-of-business managers can use such a system to determine which employees are utilizing best practices and which employees need coaching or assistance. A compensation plan management system can also be used by compensation departments to automate plan creation and payment calculations, modify compensation structures, and resolve disputes. Managers in both the lines of business and compensation departments can use the system to evaluate whether plans are achieving their intended objectives.

BENEFITS OF INCENTIVE PLAN MANAGEMENT SYSTEMS

In examining the incentive compensation challenges that banks face and interviewing banks that have deployed a professional solution for incentive compensation, Aite Group identifies six primary benefits: increased productivity, increased plan effectiveness, reduced consultant fees, improved brand protection, reduced error-driven overcompensation, and tighter alignment between compensation plans and strategy. Identified in Figure 1 with their magnitudes, ease of achievement, and ease of quantification, these benefits should be on the minds of bankers considering additional automation for their incentive compensation management.

Figure 1: Assessing the Benefits of Compensation Plan Management Systems



Source: Aite Group

INCREASED PRODUCTIVITY

When Aite Group examined banks' deployments of compensation plan management systems, productivity improvements were identified for compensation managers, compliance professionals, plan participants, and their managers.

COMPENSATION DEPARTMENT

When Aite Group examined compensation departments that adopted incentive plan management systems, two productivity-improving changes were identified:

- **Faster plan configuration**: Users of compensation plan management systems with responsibility for designing, building, and fine-tuning their banks' plans state they could complete these tasks far faster because, rather than being code-based, IBM Cognos ICM is an object- and question-based program designed for nontechnical users. One user says, "With the widgets and interactive interfaces for building plans, it now takes about 33% less time to build any given plan." Another says, "We no longer need our people to know, or program in SQL. In Cognos ICM, you program with wizards, questions, drags, and drops. It's more error-free and easier than in SQL, because there are no syntax issues."

  The monitoring of nontraditional incentives in general, and disincentives in particular, was also easier to program. One user uses Cognos ICM to improve the quality of mortgages booked by the bank and says, "Traditionally, it's so labor intensive to track disincentives using Excel or Access that almost nobody does it. But with Cognos ICM, we can configure a rule and access mortgage data necessary to penalize a retail lender who booked a mortgage that we had to repurchase after selling it off."

- **Improved accuracy**: Benefits from improved compensation accuracy and participants' higher level of trust in plans were also identified. One compensation manager is able to redeploy staff from handling routine inquiries from plan participants and says, "Accuracy of payments and the underlying justifications is critical because participant plan distrust can be elastic. If there are even a few errors, your compensation team will get a disproportionate volume of inquiries and questions. These now consume a lot less of the compensation department's time."

PLAN PARTICIPANTS

Improved accuracy is also a benefit to plan participants. Highly motivated and concerned with the accuracy of their compensation, participants in highly automated compensation plans are found by Aite Group to take advantage of participant-facing user interfaces to more efficiently double check and analyze the compensation they received from their bank. At a bank where this benefit results in a significant improvement in participant productivity, a plan manager says, "We estimate that before Cognos ICM, two-thirds of participants both maintained their own shadow compensation-tracking systems and dedicated about two to three hours to them per week. Because they can now access and check all the payment data in Cognos ICM's participant-facing capabilities, shadow accounting and double checking is probably down to less than 30 minutes per pay period."

REPORTING AND COMPLIANCE

More cost-effective regulatory compliance was a significant benefit of the standardized reporting available within compensation management systems. Here, benefits fell into two categories: less time spent incorporating compliance-related requirements into plans and more productive workflows during audits.

- **More compliant plan designs**: One plan manager who took advantage of Cognos ICM's configurability is able to more rapidly accommodate regulators' ambiguous guidelines and says, "The Fed's new requirements are not fully defined. So we have to change things as we read regulatory tea leaves and guess. In Cognos ICM, this can be done because it enables you to create a schema that matches your data. This is a lot less doable with other capabilities, which are structured based on standard org charts." Another plan manager uses Cognos ICM to create a single, governed view of plan employees across a variety of acquisitions and says, "We use attributes in Cognos ICM to get a unified view of everyone in a given role, regardless of the subsidiary or acquisition in which they might work. This is very important for regulators; they view us as one entity and don't care that one employee might be in a slightly different plan because of the acquisition in which [he or she] works."
- **Increased productivity during audits**: Once configured to accommodate regulatory requirements, plans constructed with automated systems have reporting capabilities that can be called upon for the ad hoc analyses commonly required during audits. These features enable productivity improvements for a plan manager at a Tier-1 bank who says, "Mostly because of the level of detail in the canned reports, we now spend very little time fulfilling requests from internal or external auditors and other defensive, audit-related tasks. All that time has been shifted over to plan design, which is what I actually pay my people for." Another user says, "We need to give the regulators very granular information. They want to know how many times a takeaway for adverse risk outcomes was invoked in a particular plan. It's important to prove that you have structured such takeaways and that you're doing them. We can both invoke such disincentives and prove it with standardized reports that we don't have to build."

Aite Group finds that banks use productivity improvements to reassign their employees to more important and value-added tasks. A plan manager that upgraded the responsibilities of her entire compensation department says, "We have the same number of staff today as before Cognos ICM. But people do work that is both different and more valuable. Staff now spends more time improving service to the participants and performing quality assurance on the plans to ensure that payments are accurate and [that] they are achieving their intended goals."

TIGHTER ALIGNMENT BETWEEN PLANS AND STRATEGY

Aite Group found the net effect of more finely grained plan design and improved productivity is the bank's ability to both build more plans with a given level of staff and to build those plans to conform to the bank's culture and strategy. Here, benefits fell into three areas:

- **Better management of autonomous operations:** Typically the agglomeration of many acquisitions over a long history, banks commonly find it difficult to both tightly govern the businesses they acquire while also enabling the local, value-generating culture to continue to thrive. Although this conflict can be acute in the case of compensation management, it was readily overcome by a user of Cognos ICM who says, "Because we can design plans with more granularity faster, and more often, we are able to build plans for new acquisitions that, though they match the local culture, conform to our overall strategy and compliance requirements. It can't be quantified, but this enables us to continue our strategy of letting acquisitions operate with a high degree of autonomy." A user at another bank prevented the regulatory mandates at the parent level from interfering with acquired operations and says, "While entrepreneurialism cries out for a system capable of localization, regulation cries out for something monolithic. Usually one would overwhelm the other in this conflict, with significant drawbacks. But the granularity of configuration in Cognos ICM, and the number of plans we can do, means we no longer struggle with this trade-off."

- **Better use of disincentives:** With risk management as one of their most important mandates, banks have long struggled to motivate loan officers to both book a high volume of loans and accommodate their banks' credit cultures. Traditionally, compensation plans have been the tool for motivating loan growth, while human resources levers have been useful in motivating lenders to have high credit standards. Aite Group finds that some banks are now incorporating credit concerns into their compensation plans. A plan manager at a bank that recently began using credit-focused disincentives to prevent bad loans says, "The high configurability in Cognos ICM helps us a lot. We now take compensation away from commercial lenders if a loan they booked six quarters ago has deteriorated. We want this, the regulators do also, and it's now fairly easy."

- **Improved support of new initiatives:** Continually responding to new opportunities and competitive threats, banks need their compensation plans to rapidly accommodate changes in corporate strategy. It's one thing to introduce tablet-based banking in the branches, train employees in tablet use, and hope that the technology will be adopted. It's another thing to financially motivate such an adoption so that up-sells and cross-sells happen in branches. The rapid plan construction enabled by plan management systems enables incentive compensation to play a bigger role in new strategic initiatives. At a bank that uses its compensation plan management system to accelerate the rollout of a new branch initiative, a plan manager says, "In the branches, we added a new role that is a cross between a teller and a platform person; they can both perform teller tasks and open new accounts. Maximizing the ROI on branch personnel and training is a key objective, so quickly building a plan to support this new revenue-generating role was a win for the compensation department."

INCREASED PLAN EFFECTIVENESS

The use of reporting and analytics, with which administrators evaluate whether plans are modifying behavior as intended, enables banks to continually fine-tune and improve their plans. Traditionally lacking analytical capabilities other than Microsoft Excel for making comparisons among incentive plans, compensation departments in our study have admitted to relying on gut feeling to evaluate the effectiveness of their plans prior to deploying an incentive management system. After deploying such a system, these institutions are found to be both more knowledgeable about their plan outcomes and able to quickly change incentive plans as a result of their insights. One user says, "Having the data central makes it easier to get at the data in a more consolidated way. Where we did analyses only periodically before, we now analyze continuously. The main thing we do is ensure that the plans are motivating people in the way that we expect. We've made changes based on before-and-after analyses of metrics such as average demand deposit account balances and loans booked for plan participants." Another user says, "There is a cost to something like inventing a new cross-sell role in a branch platform. We used our incentive compensation management system to determine if people newly placed in this role actually did the up-selling and cross-selling we wanted and compared it to our training and payroll costs for the initiative."

LOWER CONSULTANT COSTS

Typically having far more knowledge in payment plans and incentives than in software development, incentive compensation professionals often rely on costly outside consultants or high-cost internal IT resources to create the software code required for building and administering incentive plans. Aite Group observes a benefit of reduced costs when banks' plans are built by nontechnical compensation staff. At a bank where this benefit was achieved, a user says, "Most compensation departments rely on costly consultants to build the business logic and code a plan once it has been designed. We are actually adding two nontechnical people to our department to do this and we'll still spend less than if we relied on consultants." At these banks, the cost reductions are significant; one user says, "Our own staff working in Cognos ICM cost about one-third less than consultants." Another user says, "Independence from consultants is a big benefit. My department now builds plans with in-house nontechnical staff, who cost about $55,000 a year, compared to external developers who cost $80,000 a year." Another user emphasizes the importance of internal staffers' knowledge of a bank's culture and strategy and says, "When your own people, who know the bank's culture and strategy intimately, build the business logic for a plan instead of consultants, your plan-building meets more business requirements faster."

IMPROVED BRAND PROTECTION

Banks benefit from effective bank compensation plans when they achieve the objectives that they share with their customers and their regulators. Ideally, banks' compensation plans should pay employees fairly, mitigate systemic risk in the banking sector, and promote the judicious and cautious sale of financial instruments to the public. As a result, improved brand protection is one benefit users of compensation management plans identify. In fact, one user draws a direct connection between the bank's public image and regulators' views of its compensation plans and says, "If the Fed issues adverse findings or gives instructions about improving compensation calculations, it can wind up in the papers. Customers, who have lots of alternatives and typically use multiple banks, can react to such publicity by switching their business away from you."

REDUCED ERROR-DRIVEN OVERCOMPENSATION

Banks that adopt a compensation management system for the first time can expect to reduce payroll costs by significantly reducing error-driven overcompensation. With any manual payment-related workflow, the more rules and rule complexity there are, the higher the incidence of error-driven overpayments to employees, payments that banks cannot recover. Although compensation plan management systems are relatively mature and broadly adopted, the potential benefit of reduced compensation error should be examined by banks considering a greenfield adoption of such a system. Here, post-deployment analyses of the ROI earned on time and attendance automation systems—which are based on unfavorable errors reported by employees to their payroll departments—are instructive. Having modified the process for compensation plans, Aite Group suggests the following analysis for banks planning to replace manual compensation plan management with automated plan management:

- Estimate the rate of error-driven overpayment. Manual compensation systems, like their time-and-attendance counterparts, tend to be error prone due to the number of rules and level of rules complexity. Seeking to avoid being underpaid—but often pleased to be overpaid—employees tend to effectively report errors in payment calculations. By identifying the both the average number of underpayments per pay period and the average value of the resulting corrective payment, banks can estimate the error-based overpayment amount. As such errors tend to be symmetrical, the monthly amount of error-driven underpayment can be used, after annualization, to estimate the average annual amount of error-driven overpayments. The bank-wide compensation plan overpayment rate can then be calculated by dividing the total amount of overpayments into the total amount of compensation plan-related payroll for which it was calculated.
- Estimate the total annual value of unrecoverable overpayments by multiplying the sample error-driven overpayment rate times the bank's annual payroll attributable to compensation plans.
- Estimate the potential reduction to error-driven overpayments. Time-and-attendance systems are also instructive, which tend to reduce error rates by 90%. As a result, the total potential reduction to payroll cost is equal to the product of 90% and the total value of unrecoverable overpayments.

CONCLUSION

- Take incentive compensation complexity seriously. Although they are potent management tools, incentive plans are also complex and demanding for those responsible for plan administration. Pay-rule complexity, conflicting goals that complicate the design of plans, and limited technical resources all make it difficult for banks to launch and administer cost-effective incentive plans.
- Significant benefits are available to banks that automate plan management. Aite Group's examination of banks' compensation plan management systems identifies improved brand protection, reduced consultant fees, improved productivity, and better alignment between banks' strategic goals and their incentive plans as benefits.
- The direct benefits of compensation plan management systems can be significant. When it examines banks' deployments of compensation plan management systems, Aite Group finds that reduced consultant fees and reductions to error-driven overpayments were significant and—in the case of reduced error-driven overpayments—readily quantified.
- Do not overlook the indirect benefits of compensation plan management systems. Although less readily achieved and more difficult to quantify, the indirect benefits of compensation plan management systems—improved brand protection, lower compliance costs, and better alignment between plans and strategic goals—are also significant.
- Craft the business case. Senior compensation managers should be careful to not only consider the indirect and strategic benefits of compensation management systems but also craft the business case for adoption after considering existing consultant costs and error rates, both of which can be reduced with automation.

ABOUT AITE GROUP

Aite Group is an independent research and advisory firm focused on business, technology, and regulatory issues and their impact on the financial services industry. With expertise in banking, payments, securities & investments, and insurance, Aite Group's analysts deliver comprehensive, actionable advice to key market participants in financial services. Headquartered in Boston with a presence in Chicago, New York, San Francisco, London, and Milan, Aite Group works with its clients as a partner, advisor, and catalyst, challenging their basic assumptions and ensuring they remain at the forefront of industry trends.

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