

# Tradeoffs in Compensation 201

## SHOULD SALES PAY BE CAPPED?

By Bill Weeks, *Special Consultant, LIMRA International*

You've heard the stories. A group sales manager gets paid well up into six figures for a big case and gets fired at the end of the year for poor performance. A life agency sales manager earns nearly double what his agency manager earns, thanks to a single producer who's nicely ensconced in a lucrative niche market. But you've also heard from your sales executives that any cap on sales pay will hurt sales as it discourages making that extra call or sticking with a tough prospect through the many layers of corporate decision-making.

What is the right answer? Can you avoid inappropriate pay outcomes without demotivating your sales force? This article will look at the reasons why you should or shouldn't have a cap and how you should address the issue.

### THE CASE FOR NOT CAPPING SALES COMPENSATION

Few salespeople start their careers selling big cases. Many report that a monster case is preceded by years of building a network while honing their product knowledge and sales skills. The opportunity to get a big commission check is what keeps them plugging away despite long days filled with few if any sales. Shouldn't there be an unlimited upside to help motivate their performance and encourage them to stay with you?

In many parts of our business, salespeople have an option. If you insist on limiting their compensation, they can take the



application to another company. That other company will willingly pay their top rate on all dollars received because it is not covering benefits, training, or housing costs. What seems like a fair approach to the company comes down to a substantial economic impact to the producer.

When the difference in cash payout gets into the \$5,000 or \$10,000 range with no loss of benefits provided by their primary company, few will pass up the alternative outlet. Once a salesperson has established a relationship with another company, the door is open for them to begin sliding away from you. Is it worth the money involved to risk losing a good producer to another company?

Finally, why shouldn't you pay out the full commission scale on a large case? As a variable cost, it will only be

paid if there is the premium to support it. Your asset managers will be happy to have the additional dollars to invest. Your actuaries made no mention of any issues with large cases when you were setting your compensation plan. And, without a few large cases, it's unlikely that you will meet your sales goal for the year.

**THE CASE FOR CAPPING SALES COMPENSATION** Large cases typically put you in competition with other carriers. To get the case, companies have to reduce rates or add benefits above what their pricing called for. By paying full commis-

sion on extraordinary sales (even when the commissionable premium is reduced), companies often lose any chance they have of making a profit. To further complicate large-case sales, as size increases, the impact of poor persistency grows. While gathering a large block of assets at one time is attractive, the likelihood of paying out unearned compensation increases... making early-term lapses particularly expensive.

When commissions on a single case bring total compensation to extraordinary levels, is total compensation a fair representation of performance? Unlike many other industries, the financial services industry pays mostly on straight commission with little tie to goal or quality of sales made. This direct tie to volume often distorts our view of what is superior performance. Should a salesperson who does a small handful of cases be paid the same amount (if not more) than someone who produces the same volume based on normal-size cases? Is any single sale worth \$50,000, \$100,000, or even much more?

Payouts of that level may discourage the appropriate long-term behavior, if not encourage poor market conduct. Many promising new agents jumpstart their career by selling their "rich uncle." What may have been the right financial move for their clients often becomes a career-ending move for the agents. They lose focus on building a practice and begin "elephant hunting" without the skills or the network to do it successfully. Soon they become discouraged and find another occupation that pays a steadier income.

Particularly in institutional sales, large cases frequently require the involvement of product specialists and various levels of management. While these individuals may receive some incentive payments for meeting or exceeding sales goals, they seldom see much impact in their pay from individual sales. Although the support network was critical to making the sale, the producer receives full compensation without any adjustments. Should the producer get paid full sales commission in those cases?

The variable-cost argument is often the argument that wins the day for those advocating no cap. But that argument ignores significant opportunity costs. Particularly in smaller companies with smaller risk-retention levels and limited expertise, devoting time and expensive resources to finding and closing a big case drains time that is better spent elsewhere. Large cases can also have a negative impact on profit margins that were priced for a lower average case size.

**FINDING THE RIGHT TRADEOFF** The objective of good compensation design is to deliver fair and equitable pay in line with performance. What is the right tradeoff between motivating a hunger for sales and managing to a reasonable level of risk and profit? Finding the right answer begins with understanding your particular situation:

What is the typical range in the size of your companies'

sales? If your producers seldom sell a case over \$15,000 or \$20,000 in commission, setting a cap at \$30,000 or higher can protect you from unintended payouts without creating a morale issue.

- *How much discounting is required to win a competitive bid on a big case?* If you have to heavily discount cases beginning above size, that is a good indication of where to begin applying a cap.

- *What is the impact on profitability as a case increases in size?* Most companies target particular sizes and ages where their products are most profitable. If they sell more premiums than expected outside those bands, overall profitability will not meet expectations. Depending on your particular situation, capping the size of cases you accept can be preferable to capping compensation.

- *Do you have realistic procedures to retrieve unearned compensation paid when a case lapses or do you typically just write it off?* Those companies that do not annualize first-year and renewal commissions clearly have less need for capping, as their risk is reduced.

- *How do you treat compensation in recognition?* As your best producers are often the ones impacted by capping, recognition is particularly important to them. Recognizing the case as if commissions were paid on all dollars received helps reduce the impact of any capping.

- *How closely do benefits follow compensation?* Limiting the compensation counted toward benefits, especially pension plans, helps manage costs while keeping equity between producers and other positions of similar value that have more limited income opportunities. Many benefit experts recommend that individuals should bear full personal responsibility for funding their retirement above some (high) level.

When a company needs to protect itself against extraordinary situations but is not comfortable with an absolute cap, there are other alternatives. For instance, paying commissions at a reduced rate above some level or moving more of the total compensation to be paid on renewing premium or retained assets can be very effective. The latter is now common in corporate-owned life insurance (COLI) cases. This approach moves some of the risk to the producer without disturbing the total compensation payable.

Clearly there are strong arguments on each side of this issue. Capping producer compensation can impact producer motivation and loyalty. Companies that don't address the issues of extraordinary single cases can lose money on the very sales that they had been counting on to meet their goals. Like many other compensation design issues, large-case compensation requires a delicate blend of bipartisan politics, art, and mathematics. Particularly in this case, it is critical to determine an appropriate policy before a hasty decision is required and when there is insufficient time to determine the right tradeoff. 🌐