Example of aligning incentives

XYZ Ltd is a medium-sized advisory practice that has been running for 15 years. The business has grown to a point where it has 3000 clients, 10 sales people and 6 administration staff.

Getting ready for RDR

In preparation for the Retail Distribution Review, Barry, the MD, gave serious thought as to how to prepare the business. He also engaged a professional consultancy to help.

Previously, the firm focused on finding clients with a minimum of £50,000 to invest and who needed tax planning advice. When arranging the advice, typically tax-based planning, the firm used multiple products. The usual remuneration arrangements were:

- **Lump Sum Investments** – 4% Initial commission + 0.5% trail commission.
- **Protection** – Full initial commission.
- **Mortgages** – procurement fee or £500, whichever is greater.

Advisers are paid 80% of the commission income, with the business retaining 20% to cover operating costs and profit. The administration staff are paid a basic salary, although sometimes a small cash bonus would be paid at Christmas.

A poor client experience

Barry has identified problems with some aspects of his clients’ experience and has found it difficult to attract and retain staff. The business, while successful in the past, is now struggling to make a profit. Barry cites his difficulties as:

- The sales team continue to use a number of providers that Barry wishes they wouldn’t. He thinks it’s because of the higher commission they pay.
- Several of the advisers have threatened to leave and take clients with them, saying that another firm is prepared to pay them 90% of initial commissions.
- Some customers have complained that after the initial discussion with the adviser, they have trouble contacting them for updates.
- Absenteeism has increased in the administration team.
- Two of the best members the administration team recently left for a rival firm.

Revenue to the business has turned lumpy.

The business is just about breaking even, assuming Barry reduces on his own drawings from the firm.

Remuneration and unintended consequences

In discussion with his business consultant, Barry reflected on his remuneration policy and decided that it causes unintended consequences in his business. When commissions were higher, could afford the rates to his advisers, rebate some initial commissions to his clients and pay the occasional bonus. Nowadays, those things are impossible. The sales team is complaining about the need to bring on even more new clients to make their earnings targets.

The business consultant asked Barry to summarise the ambition for the business, which he did as follows:

- Clients should know that we work for them, not a life company.
- My people should spend as much time helping existing clients as finding new ones.
- We should deliver excellent service to our clients, as promised and every time.
- Our people should enjoy working here and feel properly rewarded and appreciated.
- We should be able to attract and retain the best people.
- We should make a healthy profit, have a more stable financial position and grow the value of the business.

Client satisfaction equals a valuable business

Barry realised that his own fortunes, through the fortunes of the business, rested firmly on a foundation of client satisfaction. To satisfy clients he had to meet their goals, which requires a safe growth in their assets. Barry came to understand that growth in Assets under Management (AUM) was the key. So, he set about designing a new structure that rewarded growth of AUM. But he also realised, that his personal goals (profitability and growth in business value) would only happen if the other stakeholders – his sales and admin teams – were equally interested in heading in the same direction.
The new scheme

Sales
- The sales team would be paid a slightly higher basic salary based on their experience and standing in the marketplace.
- Each Sales Executive would be given a ‘new AUM’ target each year. It didn’t matter what tax wrapper was used (Bond, OEIC, Pension etc).
- Each Sales Executive would have a client and asset retention target of 95% per year. Losses of clients or AUM of more than 5% would reduce the bonus.
- Barry confirmed that 40% of all future AUM revenues would go to a ‘bonus pot’ every year (40% went to run the business and 20% to profit).
- Sales Executives would earn their share of the bonus pot every three years, on a rolling basis i.e. 2010’s AUM earnings would be distributed at Christmas 2013. To qualify, staff had to be employed at distribution time. This aided retention of key staff.

Administration
- The administration team would also participate in the bonus pool in the same way as the sales team. Their share of the bonus pool would relate to their basic salary and would also be deferred on a rolling three-year basis. The bonus would be reduced if the client service teams suffered client or AUM losses greater than 5%.

Staff reaction
At first, staff were nervous. The change felt difficult and the teams thought it was about Barry’s desire to increase the value of the business in order to sell it. Barry had to carefully plan the transition to the new system. He had to make sure that the sales team in particular transitioned to the new scheme, particularly in the first three years. Barry steadily reduced the amount of initial commission being passed through to the sales team. Eventually, this was reduced to 0% on initial commissions when the bonus pool started to pay out.

The results
After five years of the change, AUM grew to £200 million upon which Barry collects an average of 0.75% client fee (£1.5 million). 40% of this goes to the rolling bonus pot (£600,000), 40% pays for running the business and the remaining 20% is profit.

In a recent interview about his successful transition, Barry said:
“I won’t pretend the change was easy. I had to do a lot of selling to convince the team this was in their interest as well as the clients. But everyone soon realised that in future years they could get a payout from the bonus pot without us having to increase the new client list at all. In fact, making sure we looked after existing clients was more valuable than just signing new ones.

Paying out the bonus pool on a rolling three-year basis also meant fewer people were tempted to leave.

Best of all, we all now focus on the same thing. Every time we do something, we ask ourselves the same thing: ‘Is this in the best long-term interest of our clients and growing their assets?’ We quickly realised that if the answer was ‘yes’, it was a ‘yes’, for all of us.

Recently my team came up with a brilliant idea. They suggested that we invest the bonus pool! Why shouldn’t it grow while they wait three years for it to pay out? I thought this was an excellent idea and asked them how we should invest it. Do you know what they said?

“They suggested that we invest in the same portfolios as those we recommend for clients. Now that’s what I call aligned interests!”