Culture of Ownership and Human Capital

Starting two months ago, and continuing this month with a lessons learned recap next month, The Findley Newsletter has been profiling those bank's that are truly exceptional performers. These are the banks that have not only survived the Great Recession, but have thrived. As we have interviewed the leaders of these banks, we continue to hear some common themes of success: having a clear long term strategy and basing all decisions off that strategy; staying true to the bank's vision; having the right people with the right skills; and empowering the employees to act as "owners" of the bank.

This last theme of success really resonates with the basic premise of Human Capital. Imagine what your bank could accomplish if every employee acted like an owner. Every decision they made was focused on the long term strategy. Every action they took moved the bank closer to long term success. Instead of their own personal gain or self interest, they put everything on the line for the success of the bank. They equated the bank's success as their personal success. That is truly exceptional!

The desire to build this employee "ownership" mindset led me to the field of behavioral economics. While some of you may have heard of the term behavioral economics or behavioral finance, it is still a relatively new field of research. In short, behavioral economics focuses on bringing the human element into business, finance, and economics. Traditional economics and corporate finance are based off the premise that we operate in a logical world. If I do X, then Y will occur. The problem is we don't live in a logical world, and as my past articles on the Cognitive Biases and the Rules of Influence show, humans base a significant portion of their decisions on emotions, gut feelings, illogical thought processes, or other cognitive biases.

So how do we create a culture of "owners", while simultaneously overcoming the biases inherent in our managers and our employees? I believe that the answer may lie in the key message from "Ending the Management Illusion" by Hersh Shefrin. Building a culture of ownership requires addressing 4 main challenges within your bank:

Financial Literacy: Your bank's financial statement is the "scorecard". Do your employees understand this scorecard? Do they know what success looks like, and how your bank compares to others? Can they understand your bank's flow of cash, and how their role impacts the cash flow?
Accurate Planning: 9 out of 10 strategic plans fail to achieve their intended goal. Mostly this is due to overconfidence within the planning process. How can you ensure your leadership is being realistic, and not optimistic in setting that bank's yearly targets?
Rewarding the Right Behaviors: Part of a acting like an owner requires you are incentivized similarly to an owner. This does not mean everyone should get stock options. The right kind of incentives reward actions that drive the long term success of the bank
Enterprise Wide Information Sharing: A bank will fail if its departments act as little silos of information. Decisions will be made with limited facts, and without a clear understanding of the situation. The sharing of information across the bank allows managers and employees to make decisions with the whole picture in mind.

Last month's article on Human Capital focused on the first two challenges of creating a culture of ownership: Financial literacy and Accurate planning. This month we will finish the series on the culture of ownership by covering the remaining two challenges: Rewarding the right behaviors and sharing information across your bank.

The First Step of Rewarding Ownership Behaviors is Defining the Right Behaviors

When connecting a culture of ownership to rewards and recognition, lets start at the very basics. If you want your employees to act like they own the bank, they need to have their goals aligned with the goals of the owners. Otherwise your employees are working to pull your bank one direction, while the board wants to steer it another direction. Cascading your bank's objectives throughout your employees' objective is the crucial pre-requisite if you want to reward your people for acting like owners. Now this may sound easy, but I can assure you that majority of companies I've worked with fail at this step.

Sherfin backs up the difficulty of performance alignment with the following studies. "A 2006 Harris survey of 23,000 employees found that 73% did not understand their organization's goals. A 2002 Franklin Covey study of 11,000 employees found that 56% did not understand the most important goals of their organization. In addition, 81% reported not having clearly identified goals." Now lets apply this to your bank. 3 out of every 4 of your employees do not have a clear understanding of your bank's vision and strategic priorities.

For sure, those 3 employees would not feel or act like an owner of the bank. In fact "the Franklin Covey study reported that 91% of the employees surveyed believe that there is only a weak relationship between their work and the major goals set by their organization. Not surprisingly, 81% feel at best weakly committed to their organization's main priorities." That says it all. Only 1 out of every 10 employees actually believes he/she is a strong contributor to the success of your bank. That 1 employee acts like an owner, while the other 9 treat the bank like it's any other job. Will your bank become a premier performer, if only 1 out of every 5 employees is fully committed to your strategy? We think no...

In order to address this performance management issue, you and your leadership team needs to build upon the new financial literacy of your employees (covered last month), and ensure that each employee has a line of sight from their job to the bank's results. Line of sight means that each employee understands how their individual performance impacts the strategic financial metrics within your bank. This line of sight is easy for some roles like your loan and commercial officers, but may be harder for you to map out for your tellers or your back office staff. And this is where a lot of companies fail. They only create line of sight for the easy roles (sales or operations), but never spend the time ensuring the more difficult roles (finance, HR, IT, customer service, front line, etc...) understand their contribution to the organization's strategic goals.

How to Reward Your Employees' Ownership Behaviors

Rewarding your employees does not just mean salary. In fact, research has consistently found that money is of is not the top priority of employees. When looking at the reasons people quit their jobs and seek other employers, inadequate salary and benefits is the fourth most frequently cited reason. Your employees are much more likely to leave you bank due to insufficient recognition (#3), a poor relationship with their manager (#2), and limited opportunities for advancement (#1).

So before you spend all your time and resources ensuring your compensation scheme is strengthening the culture of ownership, there are some other priorities that will make a bigger impact in your bank. Make sure you are providing the right development opportunities to your people, and that those opportunities are focused on achieving the bank's vision. When you are promoting people, make sure you are choosing the ones who are fully demonstrating the culture of ownership.

Within your managers, make sure they have the skills and desire to let the employees act as owners. If you have a manager who is a micro-manager or mini-dictator, then you can be sure his/her employees do not feel like an owner. And finally, make sure you are recognizing the employees who act as an owner, and make sure the rest of the bank sees their high performance. No matter what reward scheme you create, if you don't take care of these three factors, all the money in the world won't create a culture of ownership.

In order for your rewards system to strengthen your bank's culture of ownership, you can look at three different solutions, each with their own strengths and weaknesses. The first is a pay for performance compensation structure. Basically, all yearly salary increases should be linked to the performance of the individual's objectives. But as we said before, this is not as easy as it sounds. It is really difficult to create line of sight from an individual's performance objectives to the bank's strategic objectives. But when done right it is one of the most powerful reward schemes that drives a culture of ownership.

Another way to reward your employees like owners, is to have a strong bonus scheme / variable pay scheme. The problem with bonuses is that they are short term by nature, and the risk of your employees sacrificing long term strategy for short term rewards. Look at how many financial institutions were put at long term risk, due to their short term bonus chasing culture. In order for bonuses to really work, you and your leadership team need to make sure you are rewarding only behaviors that drive your long term vision, without ignoring the necessary short term returns your board demands. And once you have defined those behaviors, you need to create the line of sight for each employee, so they may understand how their actions will drive their bonus reward.

Finally, most bank's associate creating a culture of ownership with a stock incentive scheme. But just like everything else, stock ownership is a double edged sword. On one hand it creates actual employee ownership, which naturally leads to the employees making decisions like an owner. But on the other hand, pay for performance and bonus systems have a much simpler line of site from individual performance to bank performance to the final reward. Do you know all the factors that are driving the value of your bank's stock, and could you link that to individual performance objectives for your people?

For a stock system to truly work it must also follow the above rules of creating a clear definition of the behaviors you want to reward through stock, and then to create the clear line of site with the employee's performance. But unlike a bonus or pay for performance, a stock's value depends on how you calculation the value of the bank. You need to make sure you are capturing all the future cash flows predicted for your bank, not just the current asset size. It is too easy to create a stock value by using multiples, but that does not create a clear picture. Shefrin recommends using the Discounted Cash Flow methodology for stock valuation. While we agree with Shefrin, HCB also recommends using numerous valuation techniques to make sure you are overcoming the deficiencies of each individual technique.

Any of these three reward schemes can build your culture of ownership, but if you don't take the time to create clear linkages from the individuals performance to your bank's performance they won't work. This is where you and your leadership team should invest your time.

Information is Power

We all know the saying that "Information is Power", but nowhere is information more important than in a culture of ownership. Think about it… An owner can only make intelligent decisions if he/she has the right information at the right time. Wanting your employees to make decisions as if they are an owner of the bank requires the employees to have the same information that the owner would get. Unfortunately sharing more of your bank's information is not that easy. But before you start thinking about the regulatory aspect of sharing information, I am talking about the emotional and cognitive biases that will hinder your bank's ability to share the right information.

Let's start by looking at Shefrin's analysis of middle managers. "Middle managers serve as information channels between the [bank's] leadership and the front line workers. And for this reason, middle managers worry that excessive information sharing will make their functions redundant." If everyone aligned to the bank's long term strategy, its financial goals, and knows its current performance, then what extra value do the middle managers provide? As a leader of your bank, you need to keep your eye on this problem. The more you empower your employee's means the more you are taking power from your managers. If you are not careful, your managers might revolt.

Another large roadblock to information sharing relates to group dynamics. No one wants to be the bearer of bad news, because in our brains we equate bad news with disagreement and personal dislike. While this occurs a lot in peer relationships, nowhere is this more prevalent then in a leader/employee relationship. Too many people are hesitant to disagree with their boss, or provide bad news. So many times the CEO or leader does not get the whole picture, and only bits and pieces of the information is shared

In 2006, Ford hired a new CEO, Alan Mulally. At that time Ford was not doing so well, and Mulally and the leadership team created a plan to restore the company to profitability by 2009. However, Mulally noticed a disturbing trend among his leadership team and business unit heads. Each time the business unit heads would present the financial plans for their respective businesses, the aggregate total for all businesses significantly exceeded Ford's overall forecasts. "When Mulally quizzed his executives about the inconsistent numbers, one manager explained that the custom at Ford was not to share everything, but instead to hold some things back. Usually what got held back was bad news."

"When people share information, they often perceive themselves as rising or falling in social hierarchies. They worry about whom they are pleasing or displeasing. They worry about their self-images as well as the images others have of them." Your employees and managers will never act like an owner if they hoard their information. Hoarding information for power or for not wanting to displease someone leads to the same conclusion, the people making the decisions don't have all the information they need, and that often leads to failure.

<u>Putting it All Together in Creating a Culture of Ownership</u>

Mind you, building a culture of ownership is not easy, and this will not happen overnight. But if you resolve the four challenges mentioned above, then you are more likely to succeed. Everything will come together and the culture will reinforce itself. Your people will be financially literate, and understand their role in creating value for the bank. Your people will not fall victim to the planning biases, and your bank will achieve more in shorter timeframe. Your people will also be motivated to act like an owner, because you are basing their compensation on ownership results, and recognizing their efforts to add value. Finally, the information in your bank will be open to everyone, and the people that need to make decisions will do so with the whole picture, and not just the good to hear parts.

The concept of behavioral economics is only growing stronger, and Hersh Shefrin does a nice job at linking these concepts with building a culture of ownership. In the end he paints a nice picture of a premier performing organization. Imagine what you could do with a workforce like this: "A financially literate workforce participates in the creation of a realistic plan, commits to that plan, learns how their actions will affect the degree to which the company achieves the plan, are provided with the incentives that induce them to want the company to do as well as possible relative to the plan, and are given the information they need to adapt their actions in the course of implementing the plan. A company that puts all of this together is firing on all 4 cylinders."

Next month I will be taking a short break from writing the Human Capital Series. Over the next month I will be finishing and defending my MBA thesis on how to improve the Human Capital within banks in order to improve the bank's strategic performance. The Human Capital Series is scheduled to return in the July Findley Group newsletter.