

Dealer

F&I Special Section

by *Gil Van Over*



Pay Plans That Don't

The perils of unintended consequences

Life sometimes seems to be a series of unintended consequences.

Remember when you bought your new puppy dog a leather bone to chew on because you thought it would strengthen his teeth and instead he ended up chewing your golf shoes because they smelled like the leather bone? Unintended consequences.

How about the time (say January 2) when you bought a two-year membership to the gym, worked out for two hours and couldn't walk or move your arms for two days? And stopped going after two weeks. Unintended consequences.

Did you ever tell your daughter you'd give her money for good grades and later received a phone call from her algebra teacher letting you know he caught her cheating on a test? Unintended consequences.

I heard a story a few years back that is an example of an unintended consequence as the result of a pay plan. I can't confirm the validity of the story. For all I know, it could be one of those urban legends like the huge creature in the New York sewer system.

As the story goes, Microsoft decided upon a strategy in which it would release versions of its software before the software had been fully stress-tested for bugs. After all, being first to the market with a product in the software business is critical. So how did Microsoft intend to stress test the early releases?

Simply enough, it decided to pay its programmers a spiff for every bug the programmer found in the software after its release. In other words, go ahead programmers and stress-test this at home and make some extra money.

According to legend, the programmers won this battle. They decided to program bugs into the early releases, let the software release go forward, then easily "discovered" the bugs and received a handsome (or pretty) spiff. Unintended consequences.

Unintended consequences are everywhere. They even exist in your F&I managers' pay plans. After all, a pay plan is a job description.

I have yet to have a dealer refute this basic premise. Simply put, an F&I manager is going to manage her pay plan through the products she sells. For example, if her pay plan is heavily dependent on product penetration, you can bet she will sell a number of products

on most of the deals she closes. The amount of profit on negotiated products is sometimes immaterial. Jimmy Choo Shoes, here I come!

Likewise, if his pay plan rewards profit per retail over product penetration, his average profit per product sold will likely be higher and he will sell less products. New Tommy Bahama wardrobe!

There is only so much elasticity in a customer's budget for a car payment after the payments to Vicky's Secret and Needless Markup. The F&I manager's pay plan drives the distribution of back-end monies.

Now, I don't profess to be the world's leading expert on developing pay plans. In fact, when dealers ask me, I refer them to their F&I product provider. However, when I enter into a compliance consulting agreement, I like to see the pay plans. The reason? Very simply, it helps me to know what prohibited practices may potentially be taking place in the dealership. My three key focuses are: (1) Product penetration; (2) Profit per retail; (3) Balance between rate and products. Let's look at each.

Product penetration

Some pay plans set a baseline for product penetration and pay a bonus percentage if the product penetration exceeds a higher level. For example, the manager must achieve an average of one product per retail deal as the base and receives a bonus if she averages 1.4 products per retail deal.

This is a logical pay plan aimed at increasing the number of products a manager sells. It can lead to these prohibited practices:

- Bundling of products
- Product stuffing
- Trading rate for product

Bundling occurs when two or more products are sold as one product (typically service contract and maintenance), and are disclosed as one product on the buyer's order, Retail Installment Sales Contract and the product enrollment form. When the deal is recapped on an internal form the customer does not see, the products are separated by reducing the price of the product that was disclosed and allocating a sum of money to a second or more products. Tiffany can get away with bundling earrings and a necklace, but you can't bundle two F&I products.

Stuffing is different from bundling in that the allocation to pay for the undisclosed product comes from gross, not from a second product and the customer does not know he received the product.

Trading rate for product is self-descriptive. Once an F&I manager settles on the customer's APR, lowering the rate to facilitate the sale of products is a deceptive act in most attorneys general's eyes.

Profit per retail

Most pay plans are based on this simple concept...the more profit the manager generates per deal provides for a higher percentage of the profit. This stair-step approach tends to generate more profitability for the dealership, which is a good thing.

This approach, though, can also encourage an F&I manger to:

- Engage in price gouging

- Pursue excessive reserve

I think we all know what price gouging is. Selling a \$19 etch product for \$2,000 or a maintenance product for five times cost can earn you a set of iron bracelets (not the ones designed by David Yurman.)

Today's definition of excess reserve differs from last year's definition and certainly is different from five years ago and will continue to migrate toward a flat reserve system. Today, any amount of reserve over 250 basis points or 200 basis points on terms in excess of 60 months raises eyebrows and lowers the boom. The shrewd F&I manager who is working his pay plan will find a lending source that continues with twentieth-century practices and find a way to hold five points in reserve. This will pay for that 5 carat diamond for his wife, girlfriend, boyfriend, lover, soul mate, or roommate (I refuse to use the non-emotional term significant other).

Balance between rate and product

Many pay plans compensate a manager for both rate and product. The ratio between the two can lead to the deceptive practice of trading rate for product. For example, if the finance manager is paid 5 percent of the reserve he generates versus 10 percent on the product profitability, guess what is going to happen to rate. It is likely going to be traded for product while the manager is finding her balance on the Lido deck on her islands cruise.

There is not a magical pay plan available to dealerships, because if there were such an animal, everyone would be using the same plan. There are necessary risks associated with any pay plan you put into place. Just recognize that there may be unintended consequences to any plan you have and set up audit controls to help eliminate prohibited practices.

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