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5 Steps to a Well-Executed Merit Cycle

Getting the right data to make informed pay decisions is critical to maximizing your merit budget. We explain the kinds of data you need and how to apply it.

The first quarter of a new year is a time when many of our clients are executing their annual pay and performance cycle. In many areas, bonus payouts are expected to be robust this year, while salary increases are forecasted to be more modest, according to Aon's 2019-2020 U.S. Salary Increase Survey (see our article *here* for more details). With a tight labor market, it's important for employers to be mindful of stretching their merit budget further and differentiating rewards for their highest performers. Here are some key steps that will help you prepare and execute an effective performance and compensation cycle.

Step 1: Ensure Your Job Matching Is Accurate

Before you can begin the process of external benchmarking and internal decision making, it's important to ensure you're comparing like jobs to the market. As organizations grow and business operations change, internal job roles will change as well, which means that they may no longer be aligned to the right job match within your compensation survey. In addition, survey providers regularly release updated job descriptions and new jobs to reflect changes in the market. For example, our McLagan surveys release updates and new jobs annually. If your job matching is misaligned or out of date, it becomes difficult to accurately assess your compensation benchmarks relative to the market. Therefore, an annual review of your job matching is a critical first step in certifying that your merit cycle will go smoothly. McLagan survey participants can find more details on job matching by visiting McLaganLive.

Step 2: Understand Market Trends and Benchmarks

Once you have jobs matched properly against your survey provider, you'll need to consider what market data will be most useful for establishing your benchmarks. Our industry-specific compensation surveys allow clients to dynamically filter survey results and provide instant data for a look at high-demand jobs. They are designed to focus on specific segments of the financial services industry, from asset management and alternatives to Fintech, investment banking, mortgage banking, etc., and can be further refined by utilizing a select cut of firms. You can delve even deeper through segmentation of market data by geographic area. This type of customized search will yield unique compensation benchmarks, providing the insights you need to make impactful compensation decisions.

McLaganLive results also offer each participating organization a customized benchmarking view of the firm's compensation vs. the market. This presents firms with an understanding of their salary competitiveness directly within the product, without having to extract the data for further analysis.

Step 3: Review Your Salary Structures

With the latest market data in your hands, your next step is to evaluate your salary structures or job ranges (if you market price jobs individually). A few key questions you should be asking are:

- Has your salary structure become stale? When was the last time it was updated?
- Do the midpoints of your salary structures or ranges align to your targeted market percentile for pay benchmarking?
- Does your salary structure have the appropriate number of grades and are its ranges established in a way that allows for transparency and efficiency in administering your salary program?

The philosophies around salary structure vary by firm type (e.g., broad banded, traditional, market priced). However, if you leverage a more traditional structure you can quantify its effectiveness. A good way to test a traditional structure's effectiveness is to first ensure midpoints are aligned to market, and then check that approximately 60% of your employees are clustered around the middle third of the range, with around 20% in the lower third and 20% in the upper third. We discuss more about salary structures and current practices for financial services in our article, *Top Five Ways to Maintain Your Salary Structure*.

Step 4: Consider the Impact of Compensation Decisions on Pay Equity

In response to changing laws and increased awareness, many organizations have performed in-depth pay equity analyses to identify and reduce discrepancies in pay by gender or minority status. However, if you're not careful, pay changes during a merit cycle (as well as off cycle promotions and pay adjustments that are often done in a reactionary way) can re-create or exacerbate pay equity issues. It's also important note that if merit increases seem unrelated to performance or progress, they may appear unequitable.

To avoid this, companies should consider the following questions:

- What areas in our organization have historically had issues with pay equity? What level of oversight do we need to place on problematic areas?
- How can we make the process of how pay increases are determined more transparent? Should we share our salary ranges or how we develop them? Can we explain how factors like performance and experience determine employees' position within the salary range?
- Once pay decisions are submitted, should we revalidate for pay equity? How will we respond when or if we find issues?

For an in-depth discussion of pay equity and transparency and how companies can respond, see our article, *Journey to the Center of Pay Equity: Using Technology to Improve Transparency*.

Step 5: Ensure Managers are Communicating the Right Message

There are two overarching questions regarding employee communication during the merit cycle:

- What are we going to communicate?
- What should we focus on for manager education?

Managers are the first line of communication to employees regarding how merit increases are decided. While having systems in place to help explain to employees how pay is determined is critical, it will only work if managers effectively explain this connection to their direct reports.

Managers can enhance employees' understanding of compensation decisions by laying the foundation and providing context to tee up pay discussions. This may include referencing your company's compensation philosophy (e.g., we have a pay for performance culture) and individual performance. Doing so will set the stage for successful discussions surrounding merit pay decisions.

Next Steps

Our team of experienced rewards consultants can help you quickly get up to speed and advise you on next steps for your merit cycle. For more information, please contact your relationship manager or write to info@mclagan.com.

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