

How to Custom Fit Your New Pay Structure

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A poorly designed pay structure can equal disaster.

Is your organization's pay structure causing more problems than it is solving? Pay structures typically have multiple objectives, such as preserving external and internal equity, enabling career progression, enabling pay for performance and controlling costs, and often the results for each objective are quite different. A poorly designed or broken pay structure can foster misaligned pay relationships among employees and groups, hamper career progression, cause salary compression and encourage gaming of the promotion- and job-evaluation processes. Not only do these problems make it difficult for the organization to attract and retain employees, they can increase cost and create overall dissatisfaction among employees.

The need for a new pay structure arises for different reasons. In some cases, an old structure becomes tainted over time, usually by abuse of the job-evaluation system or failure to adjust to market. In

other cases, an organization may have tried "borrowing" a pay structure that worked elsewhere, only to find it never really worked for them. In some of these cases, the existing structure may need to be replaced completely with a new one that is a custom fit. Increasingly, a custom fit pay structure is one driven by market data, rather than by job evaluation. This article will explain why and how to create a market-based structure.

Start With the Market Data

In the past, when organizations could reliably market price only 5 percent to 15 percent of their jobs, they needed an internally based job evaluation approach to place jobs into a pay structure. In that approach, the jobs were leveled into the structure according to the job evaluation values and then the benchmark jobs (those that were market priced) were used to create a regression line that established the midpoints of the

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salary ranges. Today, however, most organizations can reliably market price 60 percent to 80 percent or more of their jobs. This allows them to use market data to place most jobs into a new structure or to update a market-based structure.

In Figure 1, for example, the bars represent the pay ranges for eight pay grades in a sample organization and the dots represent the market data for jobs that were placed within the grades based on internal job evaluation. It is easy to see that the market data falls outside of the pay ranges in

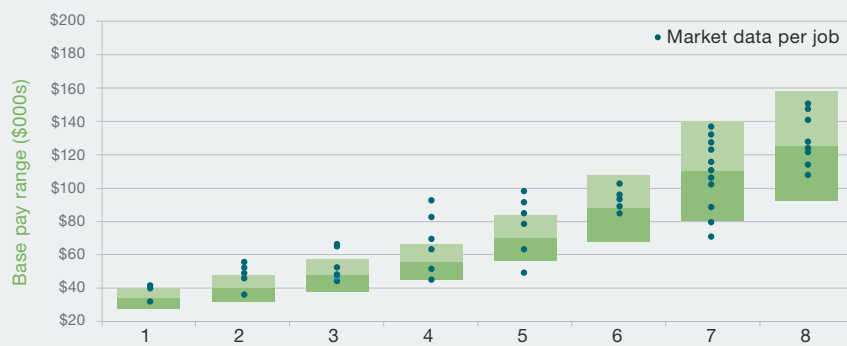
many cases, which is an indicator that the job evaluation method is not well aligned with the market.

In this example, the organization could solve some of the structural problems by adjusting the salary ranges upward, but many jobs would still have a market value outside the range or near the minimum or maximum of the range. In this case, the organization may determine that it cannot fix the pay structure without violating its own job evaluation approach. This is a good indicator that a new pay structure

driven by market data may be a good alternative solution.

The market-driven approach can work with broadbands, narrower grades or even individual job-based ranges. This approach is favored by organizations seeking greater precision in the clustering of similarly valued jobs. Because the accuracy of the market-based approach and a desire to be able to show opportunities for career progression are leading some organizations toward narrower grades rather than broadbands, this article refers to ranges as grades. For organizations seeking the flexibility and lower hierarchy of broadbands, a market-based approach can also work. An alternative for those seeking low hierarchy, greater market precision and career progression is to have multiple structures, one for each major organizational unit or function.

Figure 1 | Current Structure with Market Data



Source: Sibson Consulting

Figure 2 | New Pay Structure Considerations

Current Problems

- X% of the organization's jobs have market values outside current pay ranges
- X% of employees are at the top of current pay ranges
- Incentives are not aligned with the market
- Lack of internal equity.

Potential Benefits

- Better alignment of pay opportunity to the market
- A more competitive cost structure
- Greater pay equity and fairness
- Improved alignment of incentives
- Clearer career-progression opportunities.

Potential Risks

- The need to raise some jobs to new pay range minimums, based on market data, can be costly
- Peer relationships may be disturbed
- The current incentive alignment may be disrupted
- Some employees may have to be told they are overpaid.

Source: Sibson Consulting

this group needs to be aware of the problems with the current pay structure and the potential benefits and risks of implementing a replacement. In some cases where a new pay structure seems desirable, once the leaders understand the potential risks, a decision may be made to “patch” the current structure.

Design Alternative Structures

Many of the considerations in designing a new pay structure may seem abstract to the organization’s leaders, who must ultimately approve it. One way to avoid long and frustrating discussions about the direction and details of the structure is to solicit general direction from leadership then design several alternative structures and carefully consider the pros and cons of each. The alternative structures are built with market data first and then compared with current incumbent data.

An important decision in designing alternative pay structures is how many pay grades to include. The decision-making body should consider:

- The market values of the lowest- and the highest-paid jobs in the structure
- The desired pay range for each grade, which reflects how tightly the organization wants to manage to the market and the tolerance for creating distinctions among peer employees
- The need to group organization units (e.g., should research and development, operations, and sales and marketing be in the same or different structures?)
- The preference for one national/global structure or local/regional structures.

For example, an organization with eight pay grades with salary cost creep, claims of pay inequity and complaints about career progression wanted to evaluate one extremely different alternative, such as an 18-grade structure, and something in between, such as a 15-grade structure. Creating these alternatives in a flexible analytical model allows for relatively easy modifications and refinements to determine the

structure that is the best fit. Using these alternatives, midpoints were created using market data for the lowest and highest grades, 1-18 and 1-15. Decisions about what to call the levels, whether to use midpoints or quartiles and other aspects of how to control pay within the structure were made once an alternative was selected.

Model the Alternative Structures

The process of modeling alternative pay structures based on market data begins by determining the lowest- and highest-valued jobs in the market

that will be included in the structure. (This article will not cover the basics of market analysis, since there are many good resources available on the subject.) The desired market positioning for the lowest- and highest-valued jobs in the structure forms the midpoint for the lowest and highest pay grades in two or more alternative structures, provided the lowest- and highest-valued jobs are not anomalies relative to the other jobs and there are other similarly priced jobs in the market. If there is an anomaly, it is best to consider it nonbenchmark or leave it out of the structure.

Figure 3 | Two Market-Based Alternative Structures

Structure Alternative A									
Grade	Midpoint Progression	Range Spread	Grade Min	Grade Mid	Grade Max	Avg Salary	Compa Ratio	Avg Market 50 th	Mkt 50 th /Midpoint
18	10%	50%	\$92.5	\$115.5	\$139.0	\$113.1	98%	\$120.7	105%
17	10%	50%	\$84.0	\$105.0	\$126.0	\$103.2	98%	\$108.3	103%
16	10%	50%	\$76.5	\$95.5	\$115.0	\$96.4	101%	\$98.5	103%
15	10%	50%	\$69.5	\$87.0	\$104.5	\$88.3	101%	\$91.2	105%
14	10%	50%	\$63.0	\$79.0	\$94.5	\$79.5	101%	\$78.0	99%
13	10%	50%	\$57.5	\$72.0	\$86.5	\$70.9	98%	\$69.7	97%
12	10%	50%	\$52.5	\$65.5	\$79.0	\$65.1	99%	\$67.9	104%
11	10%	50%	\$47.5	\$59.5	\$71.5	\$58.0	97%	\$63.0	106%
10	10%	50%	\$43.0	\$54.0	\$64.5	\$53.8	100%	\$58.5	108%
9	10%	50%	\$39.0	\$49.0	\$58.5	\$48.0	98%	\$51.4	105%
8	10%	50%	\$35.5	\$44.5	\$53.5	\$42.1	95%	\$43.9	99%
7	10%	50%	\$32.5	\$40.5	\$49.0	\$39.4	97%	\$39.3	97%
6	10%	50%	\$29.5	\$37.0	\$44.5	\$38.1	103%	\$37.2	101%
5	10%	50%	\$27.0	\$33.5	\$40.5	\$33.8	101%	\$32.0	96%
4	10%	50%	\$24.5	\$30.5	\$37.0	\$31.6	104%	\$31.0	102%
3	10%	50%	\$22.0	\$27.5	\$33.0	\$28.3	103%	\$28.1	102%
2	10%	50%	\$20.0	\$25.0	\$30.0	\$25.3	101%	\$26.1	104%
1		50%	\$18.0	\$22.5	\$27.0	\$23.7	105%	\$22.5	100%

Structure Alternative B									
Grade	Midpoint Progression	Range Spread	Grade Min	Grade Mid	Grade Max	Avg Salary	Compa Ratio	Avg Market 50 th	Mkt 50 th /Midpoint
15	15%	60%	\$89.0	\$116.0	\$142.5	\$112.4	97%	\$119.7	103%
14	15%	60%	\$77.5	\$101.0	\$124.0	\$91.3	90%	\$100.4	99%
13	15%	60%	\$67.5	\$88.0	\$108.0	\$89.7	102%	\$87.5	99%
12	15%	60%	\$59.0	\$76.5	\$94.5	\$76.2	100%	\$79.1	103%
11	15%	60%	\$51.0	\$66.5	\$81.5	\$60.7	91%	\$68.9	104%
10	12%	50%	\$46.5	\$58.0	\$70.0	\$54.3	94%	\$58.5	101%
9	12%	50%	\$41.5	\$52.0	\$62.5	\$55.1	106%	\$51.3	99%
8	12%	50%	\$37.0	\$46.5	\$55.5	\$46.0	99%	\$47.4	102%
7	12%	50%	\$33.0	\$41.5	\$49.5	\$42.6	103%	\$40.2	97%
6	10%	40%	\$31.0	\$37.0	\$43.5	\$38.1	103%	\$37.2	101%
5	10%	40%	\$28.0	\$33.5	\$39.0	\$33.8	101%	\$32.0	96%
4	10%	40%	\$25.5	\$30.5	\$35.5	\$31.6	104%	\$31.0	102%
3	10%	40%	\$23.0	\$27.5	\$32.0	\$28.3	103%	\$28.1	102%
2	10%	40%	\$21.0	\$25.0	\$29.5	\$25.3	101%	\$26.1	104%
1		40%	\$19.0	\$22.5	\$26.5	\$23.7	105%	\$22.5	100%

Source: Sibson Consulting

Once the highest- and lowest-valued benchmark jobs and midpoints are determined, the remaining midpoints, minimums and maximums are a mathematical function of the desired numbers of grades, the range of the grades and the midpoint progression. These design decisions are a function of what the organization is trying to achieve and is similar to the idea of the desired “pay line” in a job-evaluation-based structure. Since all jobs will be placed in the grade with the midpoint closest to its market value, the relationship between market and midpoint will be nearly perfect for the benchmark jobs.

For example, in one organization with a few very wide pay grades, employees were frustrated that merit increases could take more than 20 years to progress significantly into their grade. Leaders were concerned that the grades were so wide that pay was out of control. In this situation, the organization wanted to test narrower grades. Another organization that had more than 100 grades was frustrated by the small differences in pay between jobs in adjacent grades, which led to constant job re-evaluations. This organization sought to test structures with fewer pay grades with slightly wider grades. The market-based alternatives may look like Figure 3.

Although this is too early to accept or reject one of the alternatives, it may be appropriate to have them reviewed by the decision-making body to see if any of the parameters need to be changed. Perhaps, for example, they also want to consider something closer to the current structure or two alternative structures that are closer to one another, say a 16- and an 18-grade structure.

Evaluate the Alternative Structures

The next step in designing a new pay structure is to evaluate the market-based alternatives with the incumbent data inserted. As shown in Figure 4, incumbents are

placed into the alternative structures according to where the market suggests benchmark jobs should be located. Once the incumbents are in the structure, the alternatives can be compared on key factors, such as the number and cost of employees with actual pay below minimum and actual pay above maximum.

It is important to review how the alternative structures would change peer relationships. Any new structure

will disrupt people with jobs in the same pay grade. Organizations must also analyze how the new structures would affect the alignment of incentive opportunities and targets. In most cases, market data will suggest a common level of incentives for jobs placed in the same market-based grade, but if the incentive eligibility and levels vary a great deal, there may need to be multiple incentive levels within some ranges.

Figure 4 | Market-Based Alternative Structures with Incumbent and Cost Implications

Structure Alternative A									
Grade	Midpoint Progression	Range Spread	Grade Min	Grade Mid	Grade Max	Below Grade Min		Above Grade Max	
						# of Inc	\$ Amt	# of Inc	\$ Amt
18	10%	50%	\$92.5	\$115.5	\$139.0	2	\$18.0	0	\$0.0
17	10%	50%	\$84.0	\$105.0	\$126.0	3	\$39.0	0	\$0.0
16	10%	50%	\$76.5	\$95.5	\$115.0	0	\$0.0	0	\$0.0
15	10%	50%	\$69.5	\$87.0	\$104.5	0	\$0.0	0	\$0.0
14	10%	50%	\$63.0	\$79.0	\$94.5	1	\$3.0	1	\$6.0
13	10%	50%	\$57.5	\$72.0	\$86.5	3	\$16.8	1	\$2.7
12	10%	50%	\$52.5	\$65.5	\$79.0	3	\$23.6	1	\$2.3
11	10%	50%	\$47.5	\$59.5	\$71.5	1	\$9.1	0	\$0.0
10	10%	50%	\$43.0	\$54.0	\$64.5	1	\$5.4	0	\$0.0
9	10%	50%	\$39.0	\$49.0	\$58.5	5	\$8.0	0	\$0.0
8	10%	50%	\$35.5	\$44.5	\$53.5	10	\$25.6	1	\$2.4
7	10%	50%	\$32.5	\$40.5	\$49.0	3	\$7.2	0	\$0.0
6	10%	50%	\$29.5	\$37.0	\$44.5	5	\$4.7	0	\$0.0
5	10%	50%	\$27.0	\$33.5	\$40.5	4	\$3.1	1	\$1.2
4	10%	50%	\$24.5	\$30.5	\$37.0	1	\$1.5	2	\$5.2
3	10%	50%	\$22.0	\$27.5	\$33.0	0	\$0.0	1	\$2.8
2	10%	50%	\$20.0	\$25.0	\$30.0	14	\$38.2	0	\$0.0
1		50%	\$18.0	\$22.5	\$27.0	19	\$11.7	0	\$0.0
Total						75	\$215.1	8	\$22.6

Structure Alternative B									
Grade	Midpoint Progression	Range Spread	Grade Min	Grade Mid	Grade Max	Below Grade Min		Above Grade Max	
						# of Inc	\$ Amt	# of Inc	\$ Amt
15	15%	60%	\$89.0	\$116.0	\$142.5	2	\$25.4	0	\$0.0
14	15%	60%	\$77.5	\$101.0	\$124.0	1	\$2.1	0	\$0.0
13	15%	60%	\$67.5	\$88.0	\$108.0	3	\$10.0	0	\$0.0
12	15%	60%	\$59.0	\$76.5	\$94.5	2	\$15.6	0	\$0.0
11	15%	60%	\$51.0	\$66.5	\$81.5	4	\$31.7	0	\$0.0
10	12%	50%	\$46.5	\$58.0	\$70.0	1	\$8.9	0	\$0.0
9	12%	50%	\$41.5	\$52.0	\$62.5	2	\$6.9	0	\$0.0
8	12%	50%	\$37.0	\$46.5	\$55.5	12	\$37.8	0	\$0.0
7	12%	50%	\$33.0	\$41.5	\$49.5	6	\$10.2	1	\$6.4
6	10%	40%	\$31.0	\$37.0	\$43.5	10	\$15.4	0	\$0.0
5	10%	40%	\$28.0	\$33.5	\$39.0	4	\$7.1	1	\$2.7
4	10%	40%	\$25.5	\$30.5	\$35.5	1	\$2.5	2	\$8.2
3	10%	40%	\$23.0	\$27.5	\$32.0	2	\$0.5	1	\$3.8
2	10%	40%	\$21.0	\$25.0	\$29.5	16	\$53.0	1	\$0.1
1		40%	\$19.0	\$22.5	\$26.5	22	\$31.7	0	\$0.0
Total						88	\$258.9	6	\$21.2

Source: Sibson Consulting

Figure 5 | Evaluation of Structure Options (example)

Criteria and Importance Rating		Existing	Alternative Options		
List criteria	Importance rating (e.g., 1-5)	Current compensation program (grades and incentive targets)	15-level structure with market competitive incentive targets	18-level structure with market competitive incentive targets	
1	Easy to administer	4	0	1	2
2	Encourages realistic career progression	4	0	2	1
3	Increases internal equity	4	0	1	1
4	Encourages pay for performance	5	0	-1	1
5	Easy to understand	3	0	1	1
6	Best accepted by leadership	4	0	0	1
7	Increases market equity	5	0	2	2
8	Minimizes potential for upset employees	3	0	-2	-1
Number of "better"		0	5	7	
Number of "same"		8	1	0	
Number of "worse"		0	2	1	
Weighted sum of "better"		0	21	34	
Weighted sum of "worse"		0	-11	-3	
Weighted decision score		0	10	31	

Source: Sibson Consulting

Gain Approval and Fine-Tune the Best Alternative Structure

Even if one structure is clearly the best fit, the authors have found it is wise to present all the alternatives to the decision-making group and help it compare them to the current pay structure, especially in terms of market fit, cost to implement and changed peer relationships. A good tool for this evaluation is the Pugh matrix shown in Figure 5. It will allow the decision-making body to refine and weight the criteria and assign a value for each criterion for each alternative.

Although one alternative structure will probably be a clear best choice at this point, it will still require fine-tuning. For example, all nonbenchmark jobs will need to be assigned to the structure. Organizations can use the whole job comparison approach, which seeks to find the closest match internally between a nonbenchmark job and a benchmark job. Or a nonbenchmark job may be compared to one or more benchmark jobs on two, three or four factors to find the best comparator job. The nonbenchmark job's grade may then be adjusted based on the degree of similarity to the benchmark job on those key factors.

Once all jobs are in the structure and the incumbent data is updated, the costs of bringing anyone who is below minimum pay into the structure must be calculated and anyone who is over the grade's maximum must be reviewed. In some cases, after a job has been assigned a grade, organizations will focus on the incumbents in those jobs and bring their pay to a specific spot within the grade based on their experience and performance against job expectations. This may take several iterations with leaders, managers and human resources, and should be calibrated across groups for fairness and cost-control purposes.

The final fine-tuning will refine the pay grade widths to balance the need to be linked to market but also be cost competitive. The decision-making body will want a final review and individual leaders will need to see how the people in their groups are affected and sign off before the new pay structure is communicated or implemented.

Conclusion

An organization with a broken pay structure needs to take action. If the current structure cannot be fixed or

if it has lost all credibility, it should be replaced. Today, organizations can consider several alternative structures that are designed and analyzed according to the linkage of the organization's jobs to market data. They can then create alternative pay structures and review the market, organization and overall financial implications (e.g., by job and by incumbent) of each. Armed with this information, leaders will be able to make informed choices that lead to a new pay structure that is a custom fit. [WS](#)

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