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Stemming the Tide of Title Inflation

While some may look at title inflation as a statistical curiosity, or a “soft” issue, and not a legitimate business concern, we have seen compelling evidence to the contrary.

By Warren Rosenstein, Head of Client Business Analysis, McLagan
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In a year where most firms will struggle to deliver bonuses that resemble the amounts paid at year-end 2006, or even 2007—both of which now feel like a long time ago—it will be tempting for firms to give promotions, in lieu of pay. Many firms have resorted to this in the past, and not with good results.

When a firm has an excessively senior staffing model, this is a situation we call “title inflation”. What follows are some thoughts on how firms wind up in this situation, what the actual consequences are, and how to unwind it, if it already exists.

CAUSES OF TITLE INFLATION

While many people imagine that “promotions in lieu of pay” is the most common cause of title inflation, and that phenomenon does exist, the simple truth is that title inflation often happens simply because no one was keeping track. Firms promote staff without measuring how “top-heavy” they are becoming, and sometimes become significantly more senior than their competitors, creating enormous pay pressures.

In some cases firms do promote employees when they have to deliver a tough compensation message, with the hope that the recognition will take some of the sting out of a disappointing bonus conversation.

And firms sometimes give promotions so that when a relatively junior employee attends a meeting, clients will think they are meeting with someone more experienced or senior. This can have a set of consequences that are outside the scope of this discussion, but it is clear that stamping “VP” on a business card only carries so much weight in convincing a client that they are getting serviced appropriately.

COMPENSATION CONSEQUENCES

Below is a sample of two hypothetical firms. The compensation numbers shown and the mix of title are illustrative, and not intended to indicate that these are real pay rates or staffing ratios.



Firm A is a reasonably staffed group, with an efficient mix of senior and junior staff for the line of business they are engaged in (the right mix varies significantly by line of business, as well as other factors). Firm B is making the same revenue, transacting the same business, and paying the same rates per title, but has some title inflation. In the first year, they require 27% more compensation dollars.

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FIRM A - Year 1		FIRM B - Year 1		FIRM B - Year 2		FIRM B - Year 3	
MD	1,000,000	MD	1,000,000	MD	900,000	MD	765,000
MD	1,000,000	MD	1,000,000	MD	900,000	MD	765,000
DIR	750,000	MD	1,000,000	MD	900,000	MD	765,000
DIR	750,000	DIR	750,000	MD	800,000	MD	765,000
VP	400,000	DIR	750,000	DIR	675,000	DIR	573,750
VP	400,000	DIR	750,000	DIR	675,000	DIR	573,750
ASSOC	250,000	VP	400,000	VP	360,000	DIR	573,750
ASSOC	250,000	VP	400,000	VP	360,000	VP	306,000
ASSOC	250,000	VP	400,000	VP	360,000	VP	306,000
ASSOC	250,000	VP	400,000	VP	300,000	VP	306,000
ANLST	150,000	ASSOC	250,000	ASSOC	225,000	ASSOC	191,250
ANLST	150,000	ASSOC	250,000	ASSOC	225,000	ASSOC	191,250
ANLST	150,000	ANLST	150,000	ANLST	135,000	ANLST	114,750
ANLST	150,000	ANLST	150,000	ANLST	135,000	ANLST	114,750
COMP	5,900,000	7,500,000		6,950,000		6,311,250	
REVENUE	15,000,000	15,000,000		15,000,000		11,000,000	
PAYOUT	39%	50%		46%		57%	

Management keeps a close eye on the funding rates at Firm B, and decides to lower their individual pay 10% in year two. Because they know some people will feel bad about the pay drop, they give a couple of extra promotions.

Let's assume revenue stays flat. Even dropping most people 10%, and paying the newly promoted officers lower, the profitability only improves marginally for Firm B. In year three, though, something goes really wrong. The top-producing MD is unhappy because he is getting paid below the market, and he leaves the firm. The revenue for Firm B drops in his absence, there is less money to go around, and the pattern reinforces itself. Firm B makes some extra promotions, drops everyone 15%, and sets the stage for another top producer to defect.

The cycle winds up reinforcing itself, and Firm B winds up with a staff of employees who feel unmotivated, because they believe they are being paid below market rates for their titles, even though they don't belong in those titles to begin with. And Firm B can no longer afford to hire the top talent that can bring in revenue, because so much of its bonus pool is tied up with over-titled staff.

MORALE CONSEQUENCES

Beyond the concern of top talent leaving over uncompetitive pay rates, an additional morale factor is that of high potential junior staff. These employees join a firm with no potential to move up through the ranks, and progress in their career paths. When these junior employees see a bloat of over-titled staff above them, it is discouraging, and it becomes harder and harder to imagine making real headway in the organization, even if it is easy to get promoted.



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INNOVATION VS. STAGNATION

Firms with title inflation often have little turnover among low performers who are over-titled: no one else wants them. While long-tenured staff with institutional knowledge and relationships is a goal that HR professionals seek to attain, there can be a stagnation of ideas associated with a top-heavy organization that has little infusion of talent.

CAN THIS BE FIXED?

This problem can seem daunting, particularly to HR and business leaders who inherit a situation where it already exists. But there are techniques to manage this problem out of the organization:

- Stop the problem at the source: tighten up the promotion process. Manage to promotion caps, derived from market data on title ratios per line of business / region, designed to normalize the title pyramid in a fixed number of years.
- Firms with global processes tend to have less title inflation. Manage to global caps.
- Firms with a more centralized process, across divisions, tend to have less title inflation. Manage across divisions.
- Develop internal criteria for each corporate title. For each business area, develop additional criteria, for example, have a level of risk managed for each trader, or a level of assets managed for a portfolio manager.
- Develop a list of employees that are clearly in inflated titles. Review job responsibilities, and benchmark their pay rates to market data based on their responsibilities, not their titles. Adjust their incentive pay rates to market-driven rates based on responsibilities. Challenge these employees to grow their performance to match their titles, or make their pay commensurate with the job they are really doing.

SUMMARY

While some may look at title inflation as a statistical curiosity, or a “soft” issue, and not a legitimate business concern, we have seen compelling evidence to the contrary. McLagan works with our clients to manage this problem out of their organizations through benchmarking title ratios, defining promotion criteria and improving title processes. For information on the 2008 Promotion Study, please contact Warren Rosenstein.

Warren Rosenstein is Head of Client Business Analysis at McLagan. Mr. Rosenstein works with clients to develop customized analysis strategy across compensation, staffing and productivity. He has provided solutions for a variety of client needs, including compensation plan design, organization structure and salary strategies.

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