The Economic Crisis, Employees, and Executives: Who Wins? Who Loses?

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Abstract: This article explores the effects of the current economic crisis from the perspective of who wins and who loses among employees and executives. While both executives and employees have suffered financially from this recession, employee losses are disproportionately more profound and are likely to have more lasting impact than losses experienced by executives. In a number of instances, executive losses may be more apparent than real.

Key Words: Executive compensation, pay equity, economic crisis.

INTRODUCTION

The recent downturn in the economy has produced more losers than winners, but who is likely to experience real loss and who may, in fact, not lose so much at all?

In recent months, we have seen the demise of several financial services organizations. Wachovia Corporation has been acquired by Wells Fargo & Co.; Washington Mutual, Inc. and Bear Sterns were acquired by J.P. Morgan Chase & Co.; Countrywide Financial Corporation is now a wholly owned subsidiary of Bank of America; Barclays PLC agreed to acquire Lehman Brothers’ North American investment-banking and trading divisions; and Bank of America absorbed Merrill Lynch.

These unprecedented events that have occurred within the financial sector have now spilled over into other sectors of the economy as well. As a result, numerous announcements have been forthcoming on a continuing basis regarding layoffs in the financial services sector, the automotive industry, construction industry, telecommunication industry, pharmaceuticals, and others. In the third quarter of 2008, 1,330 extended mass layoff events were reported that resulted in 218,158 separations. Separations due both to slack work and to bankruptcies nearly doubled over the year; layoffs due to business-ownership changes more than doubled [1].

Among the more prominent layoffs at financial institutions are the following. JPMorgan Chase & Co. announced it will lay off 9,200 or 21% of Washington Mutual Inc.’s employees by the end of 2009 [2]. Approximately half of the layoffs were expected to occur before the end of January 2009. Bank of America Corp. is expected to cut about 10,000 investment banking jobs in its combination with Merrill Lynch & Co. [3]. Citigroup Inc. plans to lay off 50,000 [4]. JPMorgan Chase & Co. may cut 3,000 from its investment banking division, according to The London Telegraph [5]. Morgan Stanley said it would cut ten percent of the staff in its institutional securities group and nine percent of its asset-management group [6]. Bank of America’s acquisition of Countrywide Financial Corp. is expected to result in more than 7,000 layoffs [7]. The total job loss for 2008 is estimated at nearly 2.6 million [8]. On January 26, 2009 alone, over 71,000 job cuts were announced, including Caterpillar (20,000), Pfizer (26,000), Sprint Nextel (8,000), and Home Depot (7,000). Total job losses for January 2009 were nearly 600,000 [9].

In an effort to restore confidence in the economy, Congress passed the Emergency Economic Stabilization Act of 2008 which authorized the Troubled Asset Relief Program (TARP) to purchase “troubled assets” and equity from financial institutions in an effort to strengthen the financial sector. $700 billion was authorized for this purpose and $350 billion was released immediately to the nine largest banks, mainly through the government’s purchase of preferred stock in the banks. To date, these actions have been insufficient to stave off the restriction of credit and the continued downturn in the economy. How to “invest” the remaining $350 billion of the original TARP funds is still under discussion with some of that funding now being considered to help the auto industry. Subsequently, Congress has passed and the President has signed an additional $825 billion “stimulus” package which they hope would help jump start the economy.

IMPACT ON EMPLOYEES

In this economic crisis, individuals who experience job loss are, without doubt, the greatest losers. They will be seeking jobs in a recessionary economy dominated by layoffs. They will be drawing upon whatever savings they have to keep up mortgage and car payments, pay off credit card debt, and provide for daily living needs. For many of these victims of the economy, the times will be exceptionally difficult.

However, those who remain employed are also being hurt financially. For example, some companies have announced that they are, or will be, eliminating the 401(k) match formerly provided to employee retirement plans. General Motors and Ford eliminated their 401(k) match for salaried employees in 2008 [10]. Motorola is temporarily suspending its 401(k) match [11] and, according to the Pension Rights Center, a consumer group, at least 38 other large companies
have publicly disclosed plans to change or eliminate contributions to their employees’ 401(k) accounts [12].

These changes are occurring on top of the losses that employees have already incurred within their 401(k) accounts as a result of the significant decline in stock market valuations over the past several months. Even employees with traditional defined benefit pension plans have been placed at greater risk because the value of the funds invested in these retirement trust accounts to provide future pension payouts have decreased as a result of declining stock market performance.

Other companies are reducing or eliminating merit increases for 2009. Human resources consulting firm Hewitt Associates has reported that salaried exempt workers could see an average base pay increase of 2.5% for 2009, less than the 3.8% employers had projected in July 2008. Non-exempt workers will see a similar decrease. Seventy-five percent of employers surveyed by Hewitt indicated that they had, or were considering, a reduction in pay raises for 2009 [13].

In addition to market losses in 401(k) accounts, suspended 401(k) matches by employers, and lower expectations for wage increases, those who remain employed are also likely to see other financial impacts from the current recession. For example, Motorola says it will permanently "freeze" its defined benefit pension plans in the United States. Benefits previously accrued to employee pensions will be preserved, but continued employment will not result in any future accruals [11]. IBM froze its traditional defined benefit pension beginning in January 2008, a move announced in 2006, preferring instead to increase the company match to its employee 401(k) savings plan [14]. This action reflects continuation of the trend in recent years of companies converting from defined benefit retirement plans to defined contribution plans to reduce labor costs and eliminate company responsibility for future pension payouts.

Even retirees are being affected by the current financial downturn. For example, Kodak has said it will make significant cuts to its retiree benefits beginning in 2009 [15]. Kodak will end dental coverage and company-paid life insurance. About 20,000 employees will be impacted by the changes. General Motors announced in September 2008 that it would end retiree health care coverage for approximately 100,000 white-collar retirees at the end of the year [16]. Other employers are expected to follow suit as a result of a 2007 decision of the U.S. Court of Appeals for the Third District permitting employers to reduce, or even eliminate, health care benefits for retirees over age 65 when they become eligible for Medicare [17]. In 2008, the U.S. Supreme Court refused to hear an appeal of the decision made on behalf of retirees by AARP [18]. Even though General Motors agreed to increase retiree pension payments by an extra $300 per month to help retirees pay for new health coverage, retirement researchers estimate that the pension increase is unlikely to offset the projected health care costs that retirees will experience.

IMPACT ON EXECUTIVES

One could argue, with substantiation, that the executives of these companies have also lost a great deal. Any stock holdings that these executives may have had in their firms have lost substantial value. At Citigroup, for example, the price of its common stock lost approximately 90% of its value in 2008. Thus, its executives also lost 90% of the value of any stock holdings they had in the company. Citigroup CEO Vikram Pandit held over 1,700,000 shares of company stock as of January 22, 2009. Assuming that these same shares were held six months previously, the market value of Mr. Pandit’s shares fell from approximately $50 million to $5 million. Similarly, James Dimon, the CEO of JPMorgan Chase, saw a decrease of approximately 50% in the value of his company stock in 2008. Mr. Dimon holds over 3.5 million shares of company stock. Hence, the value of his personal stock holdings decreased from about $175 million to $87.5 million. The stock values of other leading financial institutions have dropped similarly and their executives have encountered losses of similar proportions.

Also, any stock options held by these executives are clearly “underwater” as the current price of the stock is very likely below the grant price of the option. Hence, the options are essentially worthless - unless the price of the stock rises to former levels within the grant period, typically a period of 10 years.

A number of top executives are also forgoing bonuses for 2008. Using Citigroup again as an example, CEO Vikram Pandit, Chairman Win Bischoff, and CFO Gary Crittenden chose to receive no bonus for 2008 because of the firm’s poor economic performance [19]. Similarly, Jamie Dimon, chief executive of JPMorgan Chase & Co., Goldman Sachs Group CEO Lloyd Blankfein, Merrill Lynch CEO John Thain, and Morgan Stanley CEO John Mack chose not to seek a bonus for 2008 [20].

Some executives have chosen instead to forgo salaries or take salary cuts, presumably voluntary, going into 2009. For example, Vikram Pandit of Citigroup and AIG Chief Executive Edward Liddy have agreed to work for a salary of $1 for 2009 [21]. The CEOs of General Motors, Ford, and Chrysler Corporation have also announced plans to reduce their salaries to $1 per year if their companies receive any government bailout loans [22]. At Motorola, salaries for the company’s co-chief executive officers, Greg Brown and Sanjay Jha, will be cut by 25 percent [23]. Advanced Micro Devices Executive Chairman Hector Ruiz and CEO Dirk Meyer will each take a temporary 20% cut in base salary [24]. Also, at Caterpillar, executive compensation will be reduced by as much as half for 2009, and pay for senior managers will be cut from 5 to 35 percent [25].

IMPACT ON EMPLOYEES AND EXECUTIVES: A COMPARISON

While the financial picture described above sounds grim for employees, retirees, and executives alike, it is not yet time to shed too many tears for the executives of these firms. While the terminations, reduced salary increases, and reduced pension benefits cited previously for employees are significant and represent continuing losses, the effect of the economic downturn on executives may be less than permanent.

First, with regard to announced executive pay cuts, a 2006 report of the House Committee on Financial Services noted that from 1995 to 2005, average CEO pay increased five times faster than that of average workers. The report also noted that CEOs, on average, take home 821 times as
much as a person working for minimum wage [26]. Other studies indicate that the average CEO receives somewhere around 431 times as much compensation as the average employee [27]. Hence, even with pay cuts of up to 50%, CEOs of these major companies may still receive salaries that are over 200 times that of average employees and 400 times that of minimum wage workers. Also, for executives, base salaries are typically the smallest component of the compensation package, often accounting for only 25-30% of total pay. However, for some executives base salary is an even smaller component of total pay. For example, James Dimon, the CEO of JPMorgan Chase, had a reported salary of $1 million in 2007 but total compensation of $30 million. Hence, Mr. Dimon’s salary was only 3.3% of his total pay package. Since many top CEOs like Mr. Dimon earn salaries approximating or exceeding $1 million per year, a 50% cut may be material, but it still leaves them with $500,000 or more per year to cover living expenses. For comparison, in 2007 the average annual household income in the United States was approximately $50,233 according to the Census Bureau.

Regarding bonus concessions by top executives, one could argue that these executives should not have received any bonus or incentive award for 2008 anyway based on the firm’s performance. Typically, bonuses are to be awarded for performance that meets or exceeds established goals or expectations. They should not be entitlements for showing up at work, whatever the organizational level. And, as noted previously, even by forgoing a bonus, the salaries of executives are still many times greater than those of other employees at lower levels. Additionally, not all executives are foregoing bonuses. A review of the data to date indicates that bonus deferments affect only the CEO or a few members of the top executive team.

While some executives may be forgoing bonuses for 2008, it is likely that they are looking toward recovering these bonuses in 2009 or in the years immediately following. You might ask “What bonus can they earn in 2009 if the economy is not recovering?” To answer this question, it is necessary to understand something about how executive bonuses are determined. Most annual incentive plans for executives are what are referred to as “performance target plans.” These plans pay out incentive awards based on the degree of achievement of the company’s operating goals for the year, for example, net income or EBITDA (earnings before interest, taxes, depreciation, and amortization). Goals are typically established in relation to the previous year’s performance and payouts are usually stated in terms of a percentage of base salary. Each executive will have a target bonus expressed as a percentage of base salary. For example, a CEO may have a target bonus of 100% of base salary. Thus, if the company meets its operating target for the year, the executive would receive a bonus equal to his or her annual base salary. Since financial performance was so dismal in 2008, new operating goals can be set off these historic lows. Hence, given stabilization or any improvement in the economy, it is highly likely that these goals for 2009 will be achieved.

Additionally, most performance target incentive plans pay out a much larger bonus percentage for performance that exceeds goals. In many plans the following guidelines are common. If performance falls between 80%-100% of the operating goal, a 50% organizational payout would be authorized (that is, a payout of 50% of the executive’s bonus target percent). For performance between 100%-120% of goal, an organizational payout may run from 100% of the executive’s bonus target percent to 150% or even 200% of the executive’s bonus target percent. For performance that exceeds 120% of goal, the higher organizational payout percentage is likely to be applied. Thus, an executive with a salary of $500,000 and a bonus target percent of 60% could achieve an incentive award of $300,000 in 2009 if the company achieves its performance target.

It should also be noted that some CEOs and other executives who have forgone either a bonus for 2008 or salary for 2009, and other executives who have forgone neither, have received or are likely to receive “retention” bonuses. A retention bonus is an incentive paid to “key employees” to retain them through a critical business cycle. Typically, retention bonuses are paid out at the termination of the agreed-upon retention period; however, some companies pay them out prorata over a period of years. For example, Citigroup made “retention equity awards” in January 2008 to named executive officers and members of the senior management team whom the Compensation Committee of the Board of Directors considered to have “skills essential to managing Citigroup toward short-term and long-term recovery and performance.” These awards, which are to vest over two to four years, were said to “balance the need to retain key executives, who received significantly reduced cash and total awards, at market levels while linking their compensation to Citi’s future performance” (emphasis mine). Thus, even though Citigroup executives received reduced levels of their “standard” compensation, they received retention compensation to keep them whole at competitive market levels. Mr. Pandit, CEO of Citigroup, who chose not to receive a bonus for 2008, had received a retention bonus worth $2.5 million in January of that same year. He also received $165 million in mid-2007 when Citi bought a hedge fund that Pandit co-founded [28].

For additional perspective, it should be noted that according to company proxy filings, Goldman Sachs’ CEO Lloyd Blankfein received a bonus for 2007 of $67.9 million; Jamie Dimon of JPMorgan received an annual incentive award totaling $30 million in 2007; and Morgan Stanley CEO John Mack elected not to receive a bonus for 2007. Merrill Lynch CEO John Thain was a new hire in 2007 and received a sign-on bonus of $15 million and 500,000 shares of restricted stock.

While many executives face a permanently reduced retirement outlook because of the elimination of company matches to their 401(k) plans or frozen traditional pension plans, top executives are less likely to feel the impact of these actions because they retain non-qualified supplemental executive retirement plans (SERPs) that provide retirement benefits over and above what they would receive under their company’s qualified pension plan that is applicable to all employees. These non-qualified pension plans are intended to restore to executives pension earnings lost due to Internal Revenue Code (IRC) income caps on qualified plans.

Finally, while the valuation of previously held stock has decreased significantly, executives will continue to receive...
awards of stock and stock options going forward that have the potential for replacing or exceeding the lost value. To achieve a certain target income for each executive, companies will likely offer larger grants of stock and options (based on the stock’s lower fair market value). Because the current valuation is so low, these grants have the potential to provide exceptionally high returns when the economy improves. Some companies, however, may experience difficulty in securing sufficient shares of stock to award as shareholders express their concerns about company performance and future earnings dilution.

In an attempt to reduce some of the disparity, the Federal government has recently announced plans to cap annual compensation at $500,000 for “senior executives” of companies that receive future “exceptional” government aid. Executives would also be prohibited from receiving bonuses above their base pay. However, many critics of the plan have said that the preliminary restrictions released by the Treasury Department are overly vague and, potentially, will allow companies to circumvent the caps. For example, companies could (1) boost awards of restricted stock so that total pay is even higher than before, (2) change titles so that “senior executives” appear to be at a lower level that is exempt from the restrictions, (3) reprice underwater stock options to make them more valuable, or (4) craft lucrative new deferred-compensation or pension arrangements. Other companies receiving future federal bailout funds would have to have annual compensation above the $500,000 threshold for senior executives voted on by shareholders. However, in these instances, the shareholder vote would be nonbinding [29].

Subsequent to the administration’s proposal, however, the economic stimulus bill (The American Recovery and Reinvestment Act of 2009) passed by Congress and signed by President Obama in February 2009 imposed new and retroactive limits on top executive pay at firms receiving federal bailout funds. It requires all recipients of TARP funds to meet executive compensation and corporate governance standards to be established by the Treasury Secretary, including limits on compensation and bonuses, recovery of bonuses, and prohibition of golden parachutes. Additionally, the legislation mandates a nonbinding shareholder vote on executive compensation for institutions that have received TARP funds [30]. At this point in time, more than 350 banks and financial institutions, AIG, GM, and Chrysler have gotten funds from the government’s formal investment program [31]. These restrictions will reduce the disparity in compensation between top executives and other employees in TARP-funded organizations, but the differential impact of the economic crisis on the two groups remains significant.

CONCLUSION

During this economic crisis, both employees and executives have experienced significant financial setbacks. However, the hardship imposed by these losses is, and will continue to be, much greater for employees than executives for three reasons. First, while a few executives have lost their jobs as a result of their, and their company’s, performance, lower-level employees are clearly the target of the mass company layoffs that have been reported to date. Job loss has the most immediate and significant impact on employees and their families. Unemployment insurance, even though extended through 2009, provides for little more than basic survival. For the past 50 years, the average weekly unemployment benefit is about 35% of average weekly wages [32].

Second, employee pay is much closer to that needed for daily subsistence than is pay for executives. Salary - not bonuses, stock, or stock options - provides the basic means to pay for food, clothing, housing, and so on. Most employees are living at the margin; executives are not. Thus, even a slight reduction in employee pay has a much more significant impact on employees than a larger reduction in pay or a loss of a bonus has on executives. As was noted earlier in this article, a 50% reduction in salary for an executive earning $1 million still leaves $500,000 for living expenses. While Citigroup CEO Vikram Pandit gave up a bonus for 2009, he had received a retention bonus of $2.5 million in 2008. Similarly, Jamie Dimon, JPMorgan CEO, had received half of his 2007 bonus in cash, a sum totaling $15 million. These differences in the absolute level of compensation cannot be ignored.

Third, losses experienced by most employees (pay reductions, lost company 401(k) matches, frozen pension plans, etc.) are relatively permanent in their effect while executives have the potential, through stock and option grants awarded at current low stock valuations, to regain what they have lost, and perhaps much more, when the economy begins its recovery. Clearly, this economic crisis will have a much more profound and enduring effect on employees than it will have on the executives of the firms for whom they work. One can only hope that the crisis is short-lived.

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