Bonus Cuts, Pay Raises, Then Layoffs

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By Andrew Ross Sorkin
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It's hardly surprising that Wall Street is bracing for layoffs. The European debt crisis is rocking the markets. New regulations are crimping bank profit centers. And smaller bonuses are sending other compensation costs soaring.

Scratching your head about that last one?

In a nod to the fury and outrage from the financial crisis, Wall Street firms tempered their annual bonuses to employees last year, seemingly as a way to rein in pay. And the bonuses were largely paid in stock, aligning compensation more closely with the company's performance.

But Wall Street did not necessarily cut the overall pay packages. The dirty little secret is that to make up for the lower bonuses, many firms simply raised the base salaries. The move has been described by some government officials as a "sleight of hand."

The new pay structure is now having an unintended consequence: It is perverting Wall Street's calculus during periods of weakness.

In the past, banks could cut variable costs like bonuses when profits slipped, rather than handing out pink slips en masse.

Now, fixed costs like salaries make up a higher portion of their expenses. So layoffs are starting to look more attractive.

"An obvious short-term consequence of increasing base salaries on Wall Street is to weaken the pay-performance link — which, in turn, makes it more likely that banks will fire low-performing employees rather than simply reducing their bonuses," said Robert J. Jackson Jr., who served after the financial crisis as a deputy to the Treasury Department's pay czar, Kenneth R. Feinberg.

It remains to be seen how deeply Wall Street will have to cut. Kian Abouhossein, an analyst at J.P. Morgan Cazenove in London, says the layoffs could be painful, given the enormous fixed costs the firms face.

Mr. Abouhossein analyzed the major banks in Switzerland, which has stricter disclosure requirements than the United States but may be a good proxy for the rest of Wall Street. His research, which has been getting a lot of attention among Wall Street's higher-ups, found that 81 percent of Credit Suisse's compensation expenses are now fixed, compared with 66 percent in 2009. At UBS, they rose to 63 percent in 2010 from 55 percent.

"Increasing fixed costs increases pressure on the cost base and offers a limited cushion in the form of variable cost to absorb the impact of revenue downturns," he wrote in a note to investors. The next downturn, he explained, "is likely to lead to material staff cuts."

Last week, my colleague Susanne Craig reported that Goldman Sachs was "certain" to reduce head count this year. She reported that in January, Barclays Capital cut 600 people, or more than 2 percent of its

global staff, and she wrote that Morgan Stanley planned to cut at least 300 low-producing brokers in its wealth management division this year.

All of that may sound like small potatoes. But Wall Street is facing a new reality that it has yet to come to grips with. “Return on equity,” perhaps the best metric for considering the health of the Wall Street, fell to 8.2 percent in 2010, according to Nomura. That is down from 17.5 percent in 2005, before the crisis.

By comparison, total compensation has hardly fallen at all. At Goldman Sachs, for example, compensation and benefit expenses fell 5 percent in the first quarter. Net revenue, however, fell 7 percent during the same period. In the firm’s largest division, which includes fixed-income trading, net revenue fell 28 percent. And its annualized return on equity fell to 12.2 percent from 20.1 percent in the period a year earlier.

Alan Johnson, a pay consultant, who is still bullish on the employment market among banks, said salaries had risen 40 to 60 percent. Nevertheless, he said, “What’s really happened is you’ve traded your salary going up by $100,000 for your bonus going down $100,000.”

It is tough to find the right mix between bonus and salary. If banks got rid of bonuses altogether, they would lose the link between pay and performance.

Mr. Jackson, the former deputy pay czar, said he and Mr. Feinberg worried about this issue when they set pay limits under the Troubled Asset Relief Program. Banks have used these compensation limits as a model, albeit less than many people wanted.

“At Treasury, we anticipated that banks would seek to raise salaries in response to new rules on pay,” Mr. Jackson said. “That’s why Ken Feinberg’s rulings imposed a $500,000 cap on base salaries for most employees at the firms that received the most TARP help.”

Others wanted higher salary caps and lower bonuses. But Mr. Jackson and Mr. Feinberg figured that bankers needed compensation to be tied at least in part to the overall health of the company.

Mr. Abouhossein suggests far direr consequences: “We see higher base salaries helping underperformers in a downturn at the expense of top performers, which could result in the best people leaving the industry in a downturn.”

That could be a bit of a stretch — and a bit self-serving for the industry. Some academics and Washington officials whom I spoke with said that any suggestion that lowering bonuses would cause layoffs was a ploy by Wall Street banks to roll back their compensation changes.

Lucian A. Bebchuk, the director of the Program on Corporate Governance at Harvard Law School, said he was not convinced that raising salaries was the problem at all.

“Look, it makes things less flexible, but not in a bad way,” he said. To Mr. Bebchuk, the larger problem is that overall compensation has not come down. “I’m surprised it hasn’t come down more.”