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The Crystal Report on Executive Compensation



Citigroup Steps on the Salary Accelerator Pedal

by Graef Crystal

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A story by Eric Dash, a respected business reporter for *The New York Times*, appeared on Wednesday, June 24. It told of a plan by Citigroup Inc. to ramp up the base salaries of what were termed “the rank-and-file”, as well as to grant huge numbers of stock option shares.

Of course, none of this effects a relative handful of the company’s top executives, all of whom are subject to Federal pay controls, which, among other things, ban stock option grants.

Mr. Dash’s article says that some base salaries could be increased by as much as 50 percent.

Citigroup’s rationale seems to include:

- It needs to keep good people, It would normally do so through lavish bonuses. But these have fallen into disrepute.
- Besides, it doesn’t currently have the profits that would support lavish bonuses.
- It also argues that at least some portion of what used to be called a bonus was really base salary in drag. So increasing salaries and decreasing bonuses shouldn’t cause any serious problems.

I’m inclined to agree with the above points, at least in concept, but still I have some problems with what Citigroup is about to do.

First, increasing a base salary typically brings with it serious increases in other costs, e.g., the costs of pensions and 401(k) plans which typically are predicated on base salary, as well as the costs of life insurance, which typically is a multiple of base salary.

Second, increasing a base salary causes an increase in the fixed costs of doing business. I accept the argument that the first part of a bonus may in reality be base salary, but even so, it will prove easier to take that bonus down to zero than to effect a cut in base salary. Almost all employees expect that base salaries will never go down, even if they don't go up very fast either.

Indeed, there are many employees out there who would rather be laid-off than have their salaries cut. The reason: The lower salary that would then appear on a resume would likely result in a lower offer from a new employer.

Third, I believe the notion that the cause of the financial debacle can be laid wholly at the door of risky bonuses is too simplistic.

Granted, some bonuses in Wall Street were gargantuan and could have tempted their recipients to take on ever more risk.

But my own take was that the financial debacle was caused at least as much by a generational gap than by risky bonuses.

By the phrase "generational gap", I mean that the people at the very top of the Wall Street pyramid had never been educated in the high math needed to understand the complexities of derivatives and derivatives upon derivatives, ad nauseam. I frankly think that even the mathematicians became overwhelmed by the Frankensteinian nature of their creations.

I am also troubled by the signals being sent by the Federal government and the Congress, signals that if taken to an extreme will eventually give people in the financial services industry a pay package that closely resembles the GS schedule. Emulating the Federal government's pay policies only makes sense if you believe that the Federal government is an efficient enterprise. And anyone who believes that is, in my view, delusional.

In addition, a decision to lower bonuses that may in large part have been predicated on workgroup or individual performance, and to replace the lost bonuses with a combination of higher but inert base salaries, and stock options, the rewards under which are predicated on the performance of the entire enterprise, will likely result in less pay package motivation.

I am also troubled by the opportunistic way that Citigroup and many companies seem to be reasoning. If your stock price has risen sharply and may be in danger of either leveling or falling, you stop granting stock options and switch to free shares earned simply through the passage of time or, alternatively, free shares that you earn by not having your stock drop as much as other companies' stocks. The free shares also carry dividends, which in a downturn will respond more sluggishly to bad news than the stock price itself.

Then, when you hit rock bottom, as Citigroup has, you charter a B-52 and do an airdrop of stock options over Lexington Avenue. After all, there would appear to be little downside risk to an option when your stock has dropped to \$3.03 (its closing price on June 26) compared to a high of \$56.41 on Dec. 27, 2006.

There's an irony here. You cut bonuses and increase salaries so as to reduce risk. And then you grant large quantities of the most risky form of pay there is, namely, stock options.

At the end of the day, what have you gained?

2009 marks Graef Crystal's 50th anniversary in the executive compensation field. He has been a director of compensation for General Dynamics and Pfizer, worked as a consultant for Booz, Allen & Hamilton, served as worldwide practice director at Towers Perrin for 18 years, was a professor at the University of California at Berkeley's Haas School of Business for 10 years and a syndicated columnist for Bloomberg News for almost nine years. He has written six books and more than 1,600 articles on executive pay.