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Subject: Today's compensation Outlook for EconoPlay Subscribers (thanks!)

Employment Cost Index:

Compensation Consultants: 3Q Wages Steady as Heavy Layoffs Loom

- Health Benefits Cost Shift, Once Incremental, Now an Avalanche
- No Leverage Left for Workers; Management Bonuses Also to Be Slashed
- Wall Street's Big Problems Have Barely Just Begun to Hit Main Street

By Gary Rosenberger

NEW YORK (EconoPlay) Oct. 24 – Employers are using the blunt tool of layoffs to slash labor costs as they try to build barricades against the financial tsunami that started on Wall Street and is only now beginning to wash over Main Street, compensation consultants say.

The health benefits cost shift to workers is accelerating in what now appears to be a mad dash to high-deductible plans that hurt all but the young and healthy.

With the job market in decline, middle management and lower-tier workers have lost the negotiating leverage they had in better times and are less resistant to wage freezes that are on the rise.

Top executives are looking at sharply reduced bonuses, which will be tougher to justify to regulators, shareholders and now taxpayers – with everyone at the top echelons tainted by the high-risk ventures that created the financial crisis in the first place.

Yet average pay increases are holding steady in the third quarter for the most technical of reasons. Most increases were already budgeted and handed out by last spring, which means the traditional 3.5% to 4.0% or so wage hikes should hold through the next budget year.

At that point, wage increases will decline but only by degrees – as management looks to take care of surviving workers and not risk productivity and morale, already in a fragile state as is.

The First Casualty: Optimism

“It may be time to keep your head down and watch out for the low flying pink slips,” said Paul Gavejian, managing director of Total Compensation Solutions in Armonk, New York. “The first thing to go out the window was optimism. Now people will cut back help.”

Even something as countercyclical as healthcare has begun to feel the pinch from the bailout and everything that led up to it. “I talked to a client of mine on Monday – a premium healthcare institution in New York. They told me ‘we anticipated the usual 3.8 to 4.0 percent increase. But we’re not doing any of that now. We have got to cut our costs,’” Gavejian said.

“These guys depend on government reimbursement. But with the bailout plan, they will get squeezed on reimbursements. Government cannot continually raise money from a pot that’s empty,” he said.

Companies will cut back on bonuses and other types of variable pay as a first resort. “But if they see an industry trend to cut back on jobs, they will follow the pack,” he added. “No one wants to be the first to jump into that type of action because it costs them money in the short run. They have to pay for severance and COBRA from which they get no productivity.”

“It looks like 2009 will be a tough year for human resource departments on Main Street and employees in general,” said Jim Stoeckmann, practice leader at WorldAtWork, an association of compensation and human resource professionals.

“The scenario we have witnessed unfolding over the last year on Wall Street, beginning with bank failures, massive restructuring, the credit freeze and ultimately partial nationalization of the big banks is unprecedented,” he said.

“The result is an abundance of caution. Most companies budgeting for 2009 are caught in suspense mode as their internal planners try to estimate how deep and how long the recession will be,” he added.

“First order cost-cutting is occurring now to achieve immediate cost savings,” he said. “Actions being taken include reducing or eliminating overtime, cutting non-customer-related travel to zero, scheduling mandatory holiday shutdowns or mandatory vacations, and asking for volunteers to take extended leaves.”

WorldAtWork’s most recent survey shows about 57% of respondents are planning to decrease salary budgets next year or are undecided about it. Just 40% report no plans to change budgets, but “that number will probably drop if current trends hold,” Stoeckmann said.

Health benefits will be affected as workers take on more of the costs for premiums, deductibles and co-pays while getting less coverage, he said.

If there is any oasis of hope, it lies in the manufacturing sector, which had been the beneficiary of a weak dollar and a newfound desire to shrink supply lines as transportation costs skyrocketed, Stoeckmann said.

Benefits in Retreat

“Everyone is retreating on compensation and benefits,” said Jim Watt, president of Employee Benefit Solutions in Houston. “The stock market meltdown is not good for anyone. Everyone is hunkering down to what will be a trying 2009 and beyond, regardless of who the next president is.”

Watt sees mounting evidence of ballooning healthcare costs as workers scurry to get their medical needs attended to, something he sees in every downturn. “Employees fearful of losing

their jobs want to get everything taken care of while they still have insurance, so utilization is going through the roof,” he said.

The only thing keeping healthcare costs from catapulting further are the presidential elections, a time when insurance companies and HMOs look to remove themselves from the political agenda. (Watt has every expectation that healthcare inflation will accelerate after the elections are over.)

“Here in Houston, with its energy sector, employers are not immune to the economic woes of our times – and we’re seeing a significant retrenchment of benefits,” Watt said. “Workers are going to pay more as we move into the future. It’s a reflection of an increasingly not-so-tight labor market and companies trying to reel costs in,” Watt said.

In Houston, formerly cash-rich energy services companies that do the exploring and rig building are now rethinking their benefits packages for 2009 as major oil companies slash capital spending in tune to plunging energy prices.

Staff reductions are also inevitable as management knows full well that “employment costs become reduced in total with layoffs,” Watt said.

Locally, he has not seen large-scale layoffs yet. “It’s been mostly targeted layoffs and wage stagnation. If somebody leaves, they’re not hiring the next guy for a higher amount of pay,” he said.

Another benefits specialist has an even more troubling take. “I am not an economist, but I am a businessman who has been through a couple of these corrections. This one is different,” said Aaron Berg, president of Health Plan Manager Corp. in Mount Arlington, New Jersey.

“The stock market crashed and the rest of the economy hasn’t even begun to react to it. But a lot of people will be out of work. And a lot of businesses are going to shrink,” he said.

“What I started to see three or four months ago with companies looking to save money and try to shift their expenses to employees is really taking off now,” Berg said, adding that any prior cost-shifting was incremental and largely hidden.

“Cost shifting of benefits only happens when employers have no choice. It’s such bad PR. You don’t want to piss off your employees because at the end of the day they’re the biggest asset your company has,” Berg said. “But managements’ backs are to the wall now.”

Now, whenever he visits his clients, he comes armed with proposals for high-deductible HSA’s and HRA’s (health savings accounts and health reimbursement arrangements) that are bad for employers and worse for workers. “Because employers have to self-insure up to a point, it leaves them more exposed,” he said.

“On the employee side, it’s good only if you’re healthy. Once you use the plan and hit certain thresholds, it’s dollar for dollar out of your pocket,” Berg added. “These programs are so

demoralizing because they're so in your face. It's a time when people say 'our plan is not as good as it used to be.'"

Berg is already hearing scuttlebutt about doctors prescribing less than the recommended dosages of drugs or prescribing less of the costliest drugs, like Lipitor. And he feels neither candidate is equipped to resolve the healthcare issue in a bad economy.

"The problem isn't that insurance companies have figured out how to profit from this," he said. "The problem is the cost of delivering healthcare keep going up. Drug companies that develop products charge a lot for their product. MRI machines cost a fortune. There's a lot of really expensive space age stuff in medicine."

The only inkling of hope that could bring down the cost of health insurance "is that everyone has to be in," Berg said. "Until that point, everyone swims against the tide."

Bonuses in Peril

"Everyone is waiting for the dust to settle on the rescue plan or the bailout plan, or whatever you want to call it – but changes will take place," said David Leach of Strategic Apex Group, an executive compensation consulting group in Santa Monica, California.

"There'll be a lot of new rules for people taking money from the government, and that's going to create a blueprint going forward for everyone else on executive compensation," Leach said.

Compensation boards will need to figure out the appropriate compensation in a period of decline and failure. "The days of looking at surveys, easy answers, and rubber stamps are over," he added. "CEOs making \$2 million while workers lose their 401K retirement money are going to get scrutinized and will need to explain from a governance perspective why they deserve that much money."

Salary increases will still happen. "There's still something to be said for retaining workers," Leach said. "But that 3.5 percent formula is going to change. Some companies just can't pay it. They'll have to figure out how to better allocate pay. You can't give everyone 3.5 percent because that only encourages mediocrity anyway."

Variable pay in the form of bonuses is already in peril. "A lot of companies already have announced no bonuses or severely stripped down bonuses," he said. "Companies are managing expectations so people can brace for no bonuses."

Leach thinks employers will favor layoffs over wage cuts going forward. "It's always easier to cut staff than impose wage cuts. Wage cuts lower morale and productivity, which is really hard to overcome," he said.

"Employees' bargaining power is down right now, generally speaking," said Chris Clarke, president of Boyden Global Executive Search in Hawthorne, New York. "However, good C level people whose firms are not in jeopardy are very risk averse. Getting them to jump ship will

paradoxically be harder and therefore more expensive. Plus you cannot change a high bonus culture overnight.”

But this is also a crazy quilt world where decisions are guided by panic. “I am in Argentina, where the government has decided to nationalize private pension funds. Imagine if the U.S. government decided to steal 401K’s!”

Layoffs and Wage Freezes

Steve Gross, employee compensation leader for Mercer Human Resources Consulting, spoke to us about his latest, very revealing salary survey completed earlier this week and released yesterday, which updates an earlier April survey.

It asked 190 companies with \$2 billion in average revenues and about 2.8 million employees what they plan for 2009. “The 3.7 percent increase in April, is 3.6 percent now. So that didn’t change much,” Gross said. “Most pay increases for this year already occurred in spring when there was still optimism for the year.”

But there’s a lot to read under the covers. For instance, 24% of companies now plan to reduce the increases for next year from 3.7% to 3.2%, he said.

Bonuses will also be affected going forward. “Bonuses paid in 2009 based on 2008 performance will be reduced by 20 percent across the board and more than that for executives,” Gross said.

“Thirty percent of the companies we surveyed have already laid people off and another 37 percent are considering or planning layoffs,” he said. “The reason they’re not dramatically changing pay is because they’re going to cut their losses through layoffs.”

In addition, 11% of companies already froze wages for all or some workers this year, mostly in construction, financial services and housing-related industries, Gross added.

“When companies lay people off, they don’t expect them back in six months. It’s just not worth going through the retraining. So companies are looking at a year or more before hiring again,” he said. “That means, if you’re working, good. If you’re not working, it will be harder to find a job.”

The U.S. Labor Department is scheduled to release the Employment Cost Index for the third quarter on Friday, Oct. 31 at 8:30 a.m. ET. The above also looked ahead to 2009.

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