Halil Bader Arslan (Turkey)

The final countdown in US investment banks: what about their employees?

Abstract

This study aims to depict a brief image of US investment banks during the subprime mortgage crisis. As they have been hit the worst by the crisis, so has been its impact on their human resources. They lost almost 80% of market value and 40% of their employees.

The paper starts with an overview of the subprime mortgage crisis. It scrutinizes Bear Stearns, Lehman Brothers, Merrill Lynch, Morgan Stanley and Goldman Sachs experiences during the crisis and its impact on their employees. After a theoretical discussion on downsizing, the study examines the future prospects of employment opportunities for bankers.

Keywords: subprime mortgage crisis, investment banks, layoffs, downsizing.

JEL Classification: G01, G24, J63, M12.

Introduction

It was September 7, 2006 when Nouriel Roubini announced that an unprecedented crash in financial markets was approaching. He also persistently claimed that the crash would not only be limited with financial markets but also enfold the entire US economy and Europe (Mihm, 2008). Despite the rising oil prices and softening housing market, the US economy was still growing with low inflation and unemployment at the time of Roubini’s speech. Not more than a year later, stock markets, led by financials, were shaken by the collapse of Bear Stearns’ two hedge funds. ‘Subprime lender bankruptcy’ news dominated finance news. Gradually, the crisis jumped to commercial and investment banks, consumer confidence, consumption, manufacturing industry and employment.

Because of a variety of reasons connected with the financial system (i.e., extremely expanded mortgage loans, imprudent investments due to excessive liquidity, lack of financial supervision, etc.), US financial institutions were hit most by the unfading crisis. This was a no-winner scenario: Lenders, borrowers and agencies have lost. But, above all, ten thousands of high-qualified, well-educated, competent white collar employees stood at the top of the losers list.

Just between November and February, 500 largest US public companies laid off more than 382,691 people, according to Forbes (2009). It seems that the finance and insurance industry is one of the worst affected, in amount and size of layoffs, among all industries. US finance and insurance industry employed 6 million people in 2007 according to the Bureau of Labor Statistics data. Almost two million of them were elite workers who were deployed at managerial positions or financial operations units.

Table 1. US finance and insurance industry in 2007: employment by occupational group

<table>
<thead>
<tr>
<th>Occupational group</th>
<th>Employment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management</td>
<td>462,540</td>
</tr>
<tr>
<td>Business and financial operations</td>
<td>1,329,030</td>
</tr>
<tr>
<td>Computer and mathematical science</td>
<td>308,270</td>
</tr>
<tr>
<td>Legal</td>
<td>55,320</td>
</tr>
<tr>
<td>Sales &amp; Related</td>
<td>753,130</td>
</tr>
<tr>
<td>Office and administrative support</td>
<td>2,940,480</td>
</tr>
<tr>
<td>Other</td>
<td>142,160</td>
</tr>
<tr>
<td>Total</td>
<td>5,990,930</td>
</tr>
</tbody>
</table>


The crisis has started to hit the banks as it was spreading to the overall financial industry. The number of problem institutions jumped to 76 in 2007 and reached 117 by June 30, 2008, according to FDIC (Federal Deposit Insurance Corporation) data. The assets of problem institutions were 78 Billion USD by the first half of 2008, a record level since 1993. The number of failed banks reached 22 in 2008, as of November 21.

Table 2. Number and assets of problem institutions

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Number</td>
<td>171</td>
<td>76</td>
<td>50</td>
<td>52</td>
<td>80</td>
<td>116</td>
<td>136</td>
<td>114</td>
<td>94</td>
<td>79</td>
<td>84</td>
</tr>
<tr>
<td>Assets $ Bil.</td>
<td>116</td>
<td>22</td>
<td>8</td>
<td>7</td>
<td>28</td>
<td>30</td>
<td>39</td>
<td>40</td>
<td>24</td>
<td>10</td>
<td>11</td>
</tr>
</tbody>
</table>

Source: FDIC – Federal Deposit Insurance Corporation, Quarterly Banking Profile, Sept. 30, 2008 (* As of September 30, 2008).

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The imminent effect of the industry’s deteriorating financial and operational conditions was layoffs. The entire financial services sector announced job cuts that totaled a record 153,000 in 2007 according to the job placement consultancy Challenger, Gray & Christmas. More than half of those cuts were in the mortgage-lending business, and occurred all over the country, particularly in New York and California (Read, 2008).

Mass layoff events have also peaked. US Bureau of Labor Statistics reported the number of mass layoffs events in finance industry as 513 and the number of initial claimants to unemployment insurance 41,017 for 2007, a record high for more than a decade. As of November 2008 the numbers are 512 and 39,154, respectively.

Major securities firms, including Citigroup, Bear Stearns, UBS, Lehman Bros., Merrill Lynch, Morgan Stanley, J.P. Morgan, Bank of America, Goldman Sachs, Wachovia, Credit Suisse and Deutsche Bank, announced, in early 2008, a total of 60,200 layoffs, more than one third of those in New York (Alstein, 2008). Later, 2008 layoff estimates have jumped up to 200,000 as the crisis deepened.

1. A closer look at the investment banks

Global markets reminded that confidence is the key input in the financial business. However, this was far from just being a warning and more likely to be an epidemic plague. Merrill Lynch, Lehman Brothers and Bear Stearns, three of the five largest securities banks, no longer exist. Many regional and commercial banks collapsed, hedge funds and mortgage lenders sank. The US Federal Government has acquired Freddie Mac and Fannie Mae and become the major shareholder of American International Group, the insurance giant.

Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers and Bear Stearns were known as the top five US investment banks until early 2008. After being beaten by the unabated crisis, Bear was sold to JP Morgan; Merrill to Bank of America and Lehman went bankrupt. By the end of the week of Lehman’s bankruptcy, Goldman Sachs and Morgan Stanley applied to FED to become bank holding companies which would ensure that they’d have full access to emergency loans during the transformation process.

<table>
<thead>
<tr>
<th>Bank</th>
<th>Highest stock price in 2007</th>
<th>Highest market value in 2007</th>
<th>Av. number of employees in 2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goldman Sachs</td>
<td>$246.4</td>
<td>$107.05 bln</td>
<td>30,522</td>
</tr>
<tr>
<td>Morgan Stanley</td>
<td>$75.15</td>
<td>$83.34 bln</td>
<td>56,000</td>
</tr>
<tr>
<td>Merrill Lynch</td>
<td>$98.68</td>
<td>$150.89 bln</td>
<td>64,200</td>
</tr>
<tr>
<td>Lehman Brothers</td>
<td>$86.18</td>
<td>$59.38 bln</td>
<td>28,556</td>
</tr>
<tr>
<td>Bear Stearns</td>
<td>$170.62</td>
<td>$20.47 bln</td>
<td>13,700</td>
</tr>
<tr>
<td>TOTAL</td>
<td></td>
<td>$421.13 bln</td>
<td>192,978</td>
</tr>
</tbody>
</table>

Source: Bloomberg, Company Websites.
Table 4. US investment banks 2008

<table>
<thead>
<tr>
<th></th>
<th>Lowest stock price in 2008</th>
<th>Lowest market value in 2008</th>
<th>Estimated number of employees in 2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goldman Sachs</td>
<td>$49</td>
<td>$21.29 bln</td>
<td>28,322</td>
</tr>
<tr>
<td>Morgan Stanley</td>
<td>$9</td>
<td>$9.98 bln</td>
<td>50,600</td>
</tr>
<tr>
<td>Merrill Lynch</td>
<td>$16.25</td>
<td>$24.85 bln</td>
<td>57,200</td>
</tr>
<tr>
<td>Lehman Brothers</td>
<td>$0.05</td>
<td>$0 bln</td>
<td>0</td>
</tr>
<tr>
<td>Bear Stearns</td>
<td>$2</td>
<td>$240 mln</td>
<td>4,500</td>
</tr>
<tr>
<td>TOTAL</td>
<td>$56.36 bln</td>
<td></td>
<td>110,622</td>
</tr>
</tbody>
</table>

Source: Bloomberg, Company Websites.

2. Bear Stearns

A year ago, Bear was the firm to work at. People talked of the Era of Bear. Now it’s gone. Vanished. With more than 10,000 of its 14,000 former employees either looking for work or soon to be laid off by its new owner, JPMorgan.


It was the summer of 2007 that the hedge fund balloon, over-inflated by the risk appetite of investors, started to leak. Breaking news fell on the street that two hedge funds of Bear Stearns were almost wiped out. Company’s stock price, which had hit its top around $170 in the first days of 2007, started to plunge. Meltdown in the stock price accompanied by waning confidence of investors and other banks, precipitated Bear Stearns’ dramatic collapse. In mid-March stock price fell from $50 to $2, the price the 85 year-old company was bought by JP Morgan Chase for $240 millions. Possibly, this was one of the historical price movements for such a big bank in the world economy. “It’s a reminder that in a business based on confidence, when that confidence evaporates, so does the business”, says Roddy Boyd from Fortune Magazine (Boyd, 2008).

The layoffs began at Bear Stearns after J.P. Morgan Chase completed its takeover of the bank. More than half of Bear Stearns 14,000 employees were expected to be laid off. Moreover, many of the employees were held off from accepting new positions as J.P. Morgan Chase, apparently asked Morgan Stanley, Merrill Lynch & Co. and Credit Suisse Group management to not poach employees. To slow down the exits, employees were told they had to give the contractual obligatory 90-days notice before resigning (Woehr, 2008). On December 1, 2008, JP Morgan announced that it would trim off 9200 staff (Forbes, 2009).

3. Lehman Brothers

“Lehman’s compensation costs are so out of control that it’s going to need to break out the electric bleachers to downsize ahead of the short-selling posse. It already reassigned CFO Erin Callan and COO Joseph Gregory. The 28,100 overpaid, underworked employees who remain in place are simply ballast on Lehman’s leaky ship. In typical times, the castoffs from these sinking (or sunk) firms would have no problem finding jobs. When Drexel collapsed, or Deutsche Bank picked off Bankers Trust, or Prudential eliminated its equities business, there was always some shop on the rise, looking to hire. But these are not typical times. This time around, no firm – no area of the business – is rising.”


In 2008, Lehman faced an unprecedented loss to the continuing subprime mortgage crisis. In the second fiscal quarter, Lehman reported losses of $2.8 billion and was forced to sell off $6 billion in assets. In the first half of 2008 alone, Lehman stock lost 73% of its value as the credit market continued to tighten.

In August 2008, Lehman reported that it intended to release 6% of its work force, 1,500 people, just ahead of its third-quarter-reporting deadline in September (Anderson, Dash, 2008). On August 22, 2008, shares in Lehman closed up 5% (16% for the week) on reports that the state-controlled Korea Development Bank was considering buying Lehman. After it was reported that the state-run South Korean firm had put talks on hold, Lehman’s shares plunged 45% to $7.79.

Investor confidence continued to erode as Lehman’s stock lost roughly half its value and pushed the S&P 500 down 3.4% on September 9, 2008. The Dow Jones lost nearly 300 points on the same day on investors’ concerns about the security of the bank. The U.S. government did not announce any plans to assist with any possible financial crisis that emerged at Lehman (Anderson, 2008).

On September 13, Lehman reported that it had been in talks with Bank of America and Barclays for the company’s possible sale (Anderson, Dash, Bajaj, Andrews, 2008). The New York Times reported next day that Barclays had ended its bid to purchase all or part of Lehman and a deal to rescue the bank from liquidation collapsed (White, Anderson, 2008). On September 15, Lehman filed for Chapter 11 bankruptcy protection, the largest bankruptcy in U.S. history. The date was the end of a 158 year-old financial giant.
On September 20, 2008, a revised proposal to sell the brokerage part of Lehman Brothers holdings of the deal, was put before the bankruptcy court, with a $1.35 billion plan for Barclays to acquire the core business of Lehman Brothers (mainly Lehman's $960 million Lehman's Midtown Manhattan office skyscraper, with responsibility for 9,000 former employees), was approved. Manhattan court bankruptcy Judge James Peck ruled: “I have to approve this transaction because it is the only available transaction” (BBC, 2008). Barclays had a potential liability of $2.5 billion to be paid as severance, if it would choose not to retain some Lehman employees beyond the guaranteed 90 days.

On September 22, 2008, Nomura Holdings announced it agreed to acquire Lehman Brothers' franchise in the Asia Pacific region including Japan and Australia. The following day, Nomura announced its intentions to acquire Lehman Brothers' investment banking and equities businesses in Europe and the Middle East. A few weeks later it was announced that the terms of the deal had been met, and the deal will become legally effective on Monday, October 13 (Nomura Holdings, 2008).

Among all CEOs, Lehman’s CEO Richard Fuld was probably the one most exposed to public criticism, due to his compensation. On October 6, House Oversight and Government Reform Committee invited Lehman’s CEO Richard Fuld to testify on his company’s failure. During the testimony, the chairman of the committee, Waxman, held up a chart suggesting that Fuld's personal remuneration totalled $480 mln over eight years — including payouts of $91 mln in 2001 and $89 mln in 2005 and asked: “Your company is now bankrupt and our country is in a state of crisis. You get to keep $480 mln. I have a very basic question – is that fair?”. Waxman also listed Fuld's collection of property – including a $14 mln ocean-front villa in Florida, a home in the exclusive ski resort of Sun Valley, Idaho and an art collection filled with million dollar paintings (Clark, Schor, 2008). Lehman’s biggest mistake was buying mortgage-backed derivatives, even though it was primarily a bond-trading specialist. Either Richard Fuld underestimated the degree of the current crisis or he may have overestimated his ability to manage it (Dell, 2008).

4. Merrill Lynch

The company was founded on January 6, 1914. With $150 billion market value and 64,200 employees, it was the biggest investment bank in USA in 2008. 2007 was a critical year in Merrill’s history. On November 1, 2007, Merrill Lynch’s CEO Stanley O’Neal left the company, after being criticized for the way he handled the subprime mortgage crisis, which resulted in about $2.24 billion of unexpected losses, and for unauthorized attempts for a possible merger with Wachovia. He left Merrill Lynch with about US $161 million worth of stock options and retirement benefits. John Thain, CEO of the New York Stock Exchange, succeeded him as CEO on December 1, 2007. In December 2007, the firm announced it would sell its commercial finance business to General Electric and sell off major shares of its stock to Temasek Holdings, in an effort to raise capital. The deal raised over $6 billion. Merrill Lynch reported a $9.83 billion fourth quarter loss incorporating a $16.7 billion write down of assets associated with subprime mortgages. The bank eliminated 1100 positions in coming weeks (Luhby, 2008a). On April 17, 2008, Merrill Lynch reported a net loss of $1.97 billion for the first quarter of 2008 (Merrill Lynch, 2008). On the same day, the headquarters announced to cut the other 4000 positions which would slash costs 800 million annually (Barr, 2008). In one year between July 2007 and July 2008, Merrill Lynch lost $19.2 billion (Story, 2008). Merrill Lynch’s total loss from mortgage-backed securities has reached $51.8 billion in September 2008 (Miller, Ho, 2008).

On September 14, 2008, Bank of America announced it was in talks to purchase Merrill Lynch for $38.25 billion in stock. On September 15, on the same day with Lehman’s bankruptcy, Bank of America bought Merrill Lynch in a $50-billion all-stock ($29 per share) transaction. The deal value was quite interesting in that the price was 70.1% higher than the last closing price and 38% higher than its book value. The acquisition made Bank of America the largest brokerage in the world, with more than 20,000 advisers and $2.5 trillion in client assets.

Only after three months Bank of America shares have fallen 46%. On December 11, 2008, Bank of America announced its plans to eliminate 35,000 jobs over the next three years as it absorbed Merrill Lynch and contended with the deepening recession. The bank had 247,000 employees, as of Sept. 30, while Merrill Lynch had 60,900 at the end of the third quarter (Luhby, 2008b). On December 15, Merrill posted the other 400 cuts in staff (Forbes, 2009).

5. Morgan Stanley

Morgan Stanley was one of the two lasting investment banks with Goldman Sachs by September 2008. However, fear and rumours have pushed its stocks down more than 80% (from 2007 peak $75.11 to $9). Following the Lehman event, Morgan shares plunged 52% just in four days. The company was said to explore merger possibilities with CITIC, Wachovia, HSBC, Banco Santander and Nomura (Jagger, 2008).
On September 22, 2008, Morgan Stanley and Goldman Sachs, both announced that they would become traditional bank holding companies, bringing an end to the 75-year era of investment banking on Wall Street. On the same day, Morgan Stanley is said to be in talks to sell up to 20% of the bank to Mitsubishi UFJ Financial group (Kollewe, Teather, 2008). After two weeks, on October 13, Mitsubishi UFJ Financial Group and Morgan Stanley announced that Mitsubishi has closed on a $9 billion equity investment in Morgan Stanley that gives Mitsubishi a 21 percent ownership interest in Morgan Stanley on a fully diluted basis (Morgan Stanley, 2008). The deal helped Morgan Stanley to get off lightly from the financial meltdown. A similar picture appears when it comes to redundancies.

The bank laid off less than 10% of the staff, a better rate comparing to others. 4,400 workers were made redundant by November 2008 (Guerrera, Van Duyn, 2008). On December 16, 2008, Morgan Stanley reported an unexpected $2.3 billion quarterly loss. Employees at Morgan Stanley suffered as a result of the poor performance during the quarter as the company's bonus pool was cut in half from a year ago (Ellis, 2008).

6. Goldman Sachs

Despite the 2007 subprime mortgage crisis, Goldman was able to profit from the collapse in subprime mortgage bonds in the summer of 2007 by selling subprime mortgage-backed securities (Quinn, 2007). However, that was not enough to save Goldman’s shares’ overwhelming slump to $49 from 2007 peak $246.

Goldman Sachs, the top-ranked adviser on mergers and acquisitions, and the last standing investment bank with Morgan Stanley gave up its investment bank status and transformed into a traditional banking company on September 22, 2008.

On October 23, 2008, Goldman Sachs announced its plans to eliminate 3,200 workers (Moullaklis, 2008). On December 16, 2008, the bank posted its first quarterly loss, since going public in 1999, $2.12 billion. Firm's compensation pool slumped by 46% in its 2008 financial year, down to $10.98 billion, meaning that the staff will share in a much smaller bonus (Quinn, 2008).

7. Do they downsize?

Unofficial estimates show that 80,000 bankers, who were previously employed by these investment banks (Tables 3, 4) have lost their jobs. Putting aside Lehman’s bankruptcy, the primary reason for redundancies is cost reduction. The average annual wage in the finance industry is $53,190, and average annual benefits paid by the employer are $25,180, according to Bureau of Labor Statistics data (2009). Assuming that all the redundant employees earned the same wage and were given the same amount of benefits, the finance industry would save $4.25 billion annually. Adding it the benefits, total savings of the industry from 80,000 layoffs would be $6.27 billion per year. The critical question is whether the redundancies could be regarded as downsizing or not?

Downsizing refers to the planned (proactive) elimination of jobs, positions, hierarchical levels and processes in order to increase efficiency, productivity and competitive power (Cascio, 1993; Godkin et al., 2002; Freeman, Cameron, 1993). Organizational downsizing has been a major cost reduction strategy for many firms. Today, the bottleneck in financial markets forces banks to reduce their headcounts. However, one should not see the layoffs in banking industry as complete downsizing practices. They are more likely workforce reductions due to organizational decline.

Workforce reduction is not the same phenomenon as the downsizing. It is a common response to organizational decline (Greenhalgh et al., 1988). Downsizing involves many alternatives beyond just laying off personnel. Organizations may get smaller through headcount reduction such as attrition, early retirements or outplacements. Downsizing may occur by reducing work, not just personnel, by eliminating functions, hierarchical levels or units. Organizational decline is also different from downsizing. Decline refers to the involuntary loss of resources, generally revenues, and market share; and often leads to dysfunctional effects on organizations such as, decreasing levels of morale, trust, communication, innovation and increasing levels of conflict, scapegoating and conservatism (Cameron et al., 1991).

Subprime mortgage crisis destructed investment banks’ financial structures. Bear and Merrill have been sold, Lehman bankrupted. Goldman Sachs and Morgan Stanley transformed into bank holding companies. Goldman Sachs reported loss for the first time in its publicly traded history and Morgan Stanley sold 21% of its shares to Mitsubishi UFJ. These were not intentional, eagerly growth oriented steps for those banks but rather the lesser of two evils. Therefore, it would be true to regard the redundancies in these firms as workforce reductions in response to organizational decline.

Near future and conclusion

Not only the ones listed above, most financial institutions trim their workforce as a response to the perfect storm in markets. Job cuts will most probably continue in 2009 and reach up to 350,000
globally, due to melting profits (Lagerkranser, 2008). As overall risk taking ability would be curbed and this will lower profits too.

This is far from being a cost reduction and more likely to be an organizational restructuring for most institutions. The job losses are expected to be concentrated in the investment banking and trading businesses. A recent study by the Federal Reserve concluded that New York City alone could lose between 55,000 and 78,000 financial jobs over the next few years (Guerrera, Van Duyn, 2008).

Investment banks will probably retreat from risky businesses and retrench to their traditional core competence of advising on acquisitions, providing research and underwriting stocks and bonds. However, if the recession will last longer, merger and acquisition volume will not be enough to create adequate profits for those banks. Once the economy starts to improve, mergers and acquisitions and equity underwriting work should pick up again. Other segments, like fixed income, will take longer to return to normal. Bankers who specialized in highly structured products like CDOs and derivatives will suffer more.

The imminent effect of this period for survivors is pay cuts. Many banks have curbed bonus payments already. For individuals, who have worked in investment banking business and been laid off, emerging markets such as Hong Kong, Brazil, Shanghai, Dubai and Istanbul may be appropriate opportunities for future employment.

Horace (65-BC), the Roman lyric poet says: “Make money, money by fair means if you can, if not, but any means money”. This idea of making money might have been exaggerated by financial institutions during the last decade. Whether the liberal market mechanism worked wrong, or agencies misinterpreted it, the entire financial system suffered from the consequences.

References