2006 Financial Services Compensation Update and Projections

Presentation and Discussion

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Introduction

- Discussion of current compensation issues for financial firms and year-end projections

Johnson Associates

- Boutique independent compensation consulting firm specializing in financial services. Pure advice, annual and long-term incentive designs, market levels, and performance goals/measures. Expertise and in-depth knowledge across comparator groups and labor markets
  - Opinionated and informed

- Diverse Clients
  - Investment and commercial banks
  - Asset management firms
  - Hedge funds/Private Equity/Alternatives
  - Insurance companies
  - Brokerage firms
  - Trading organizations

2006 Year-End

- Clearly and broadly increased compensation levels versus 2005
  - Up across industry sectors
  - Strength in derivatives
  - Investment banking
- Accelerating staffing increase
  - Focus on high-end talent
  - Make-up for last several years
- Steady compensation accrual rates. Moderating subsidies to investment banking and equities along with product build-outs
  - International now prominent and self-sustaining
- Clear compensation pressures at associate/VP levels
  - As importance of "processing" declines, relative value of new high-end talent increases
- Heavy restricted stock use
  - FAS 123R takes full effect both economically and emotionally
  - Stock options slowly return over 2007-2009

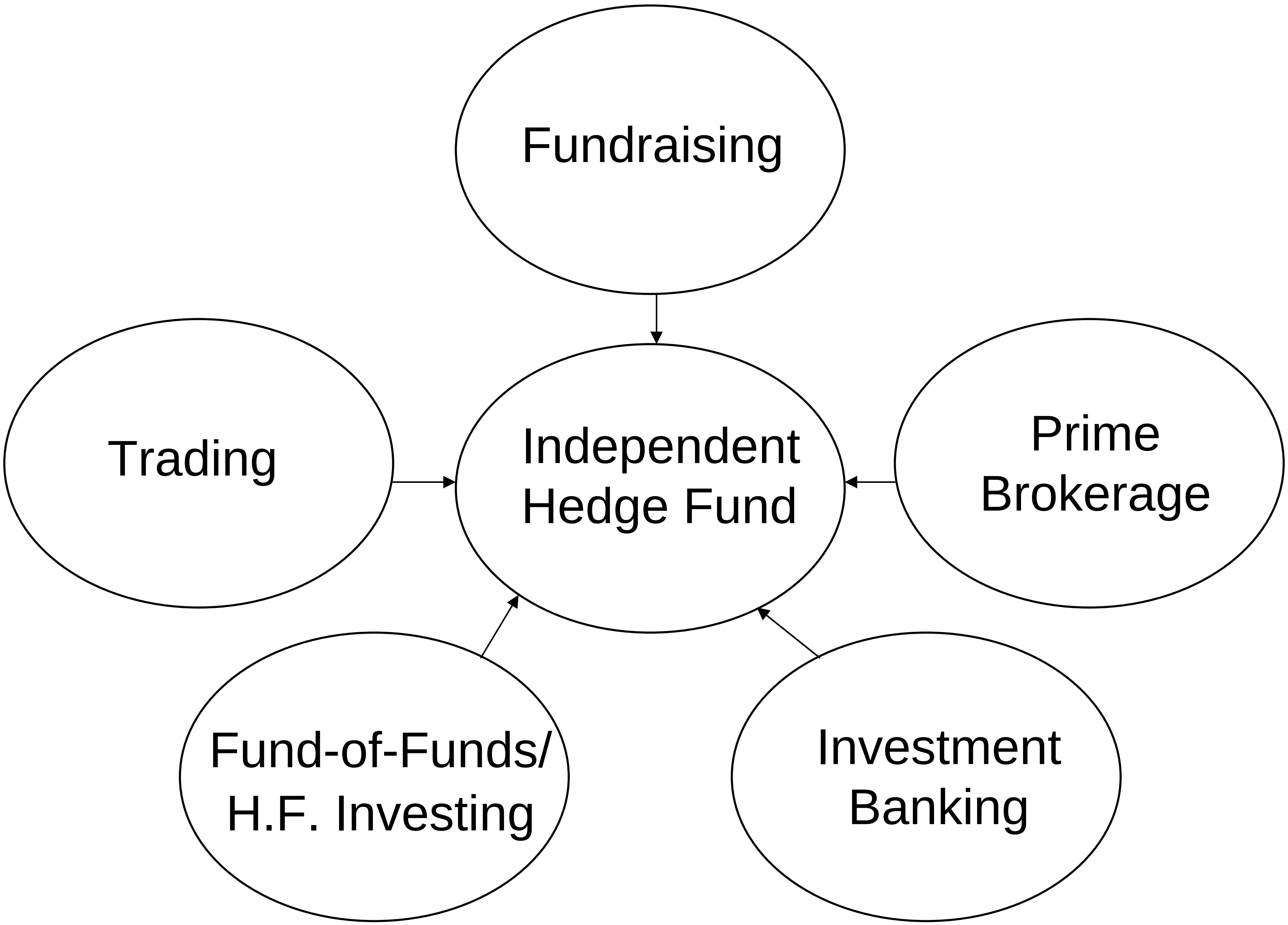
2006 Year-End

- Importance of firm scale more apparent and pronounced
  - Large firms outpace/outpay competitors
  - Across investment banks, alternatives, and asset management
- Competition across high-net worth and asset management/alternatives
  - Compensation conflicts with core businesses continue
- Independent Hedge funds/Fund-of-Funds/Private Equity serious talent threats at margin. Alternatives clearly established as long-term asset class
  - Hiring for both front and back-office
  - Their compensation analyses include broader firms
- Cost-of-living differences clearer issue in compensation
  - No need to provide same compensation in Dallas vs. New York
  - London costs driving perception of higher compensation in Europe
- MGMC credible data provider, but perceived decline at McLagan
  - Renewed battles over data credibility and meaning
- Diverging benefit models in marketplace
  - Pension vs. no pension
  - Purely financial perspective and uneven advice quality

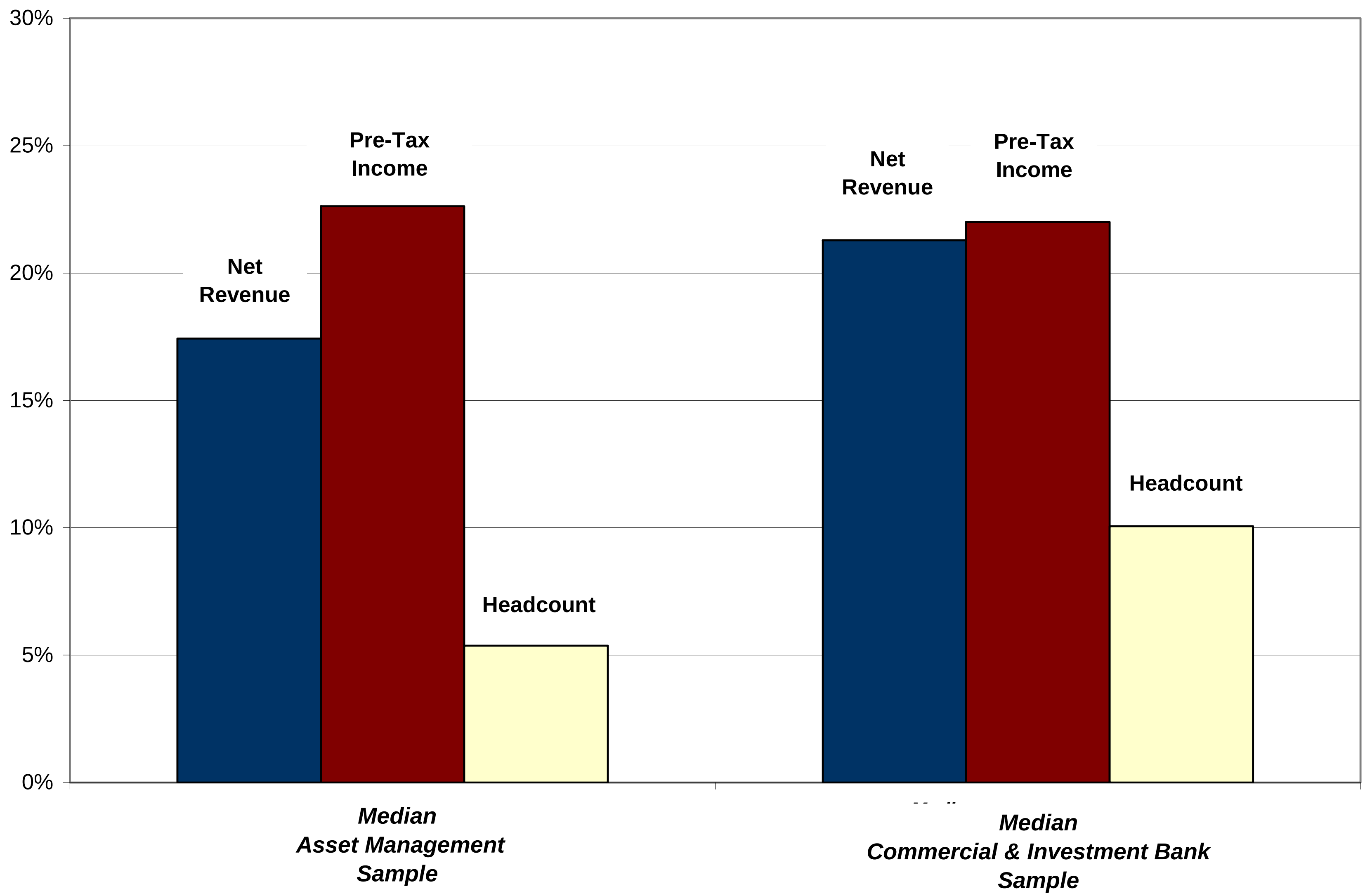
2007 Fearless Predictions

- 2007 excellent business and compensation environment
  - Rebound in investment banking and equities continues
  - Major international opportunities
  - Strong trading (i.e., spreads, and risk)
  - Retail brokerage stronger
  - Asset management environment better, but institutions lag
  - Commercial banking continues strong
  - Pell-mell rush to alternatives continues but rotating among choices
  - Retail banking under more stress
- Conflicts become major issue for diversified firms
  - Amnesia regarding dot com era
- Headcount accelerates (i.e., 5%+ net above year-end 2006)
- Outsourcing from high cost areas temporarily moderates
- Investment Banking pay up significantly again and again (i.e., 20%+)
- Private equity fully returns, hedge funds grow, and aggressive international investing enters the mix, plus real estate
- Broadened use of gardening leave and selective non-competes

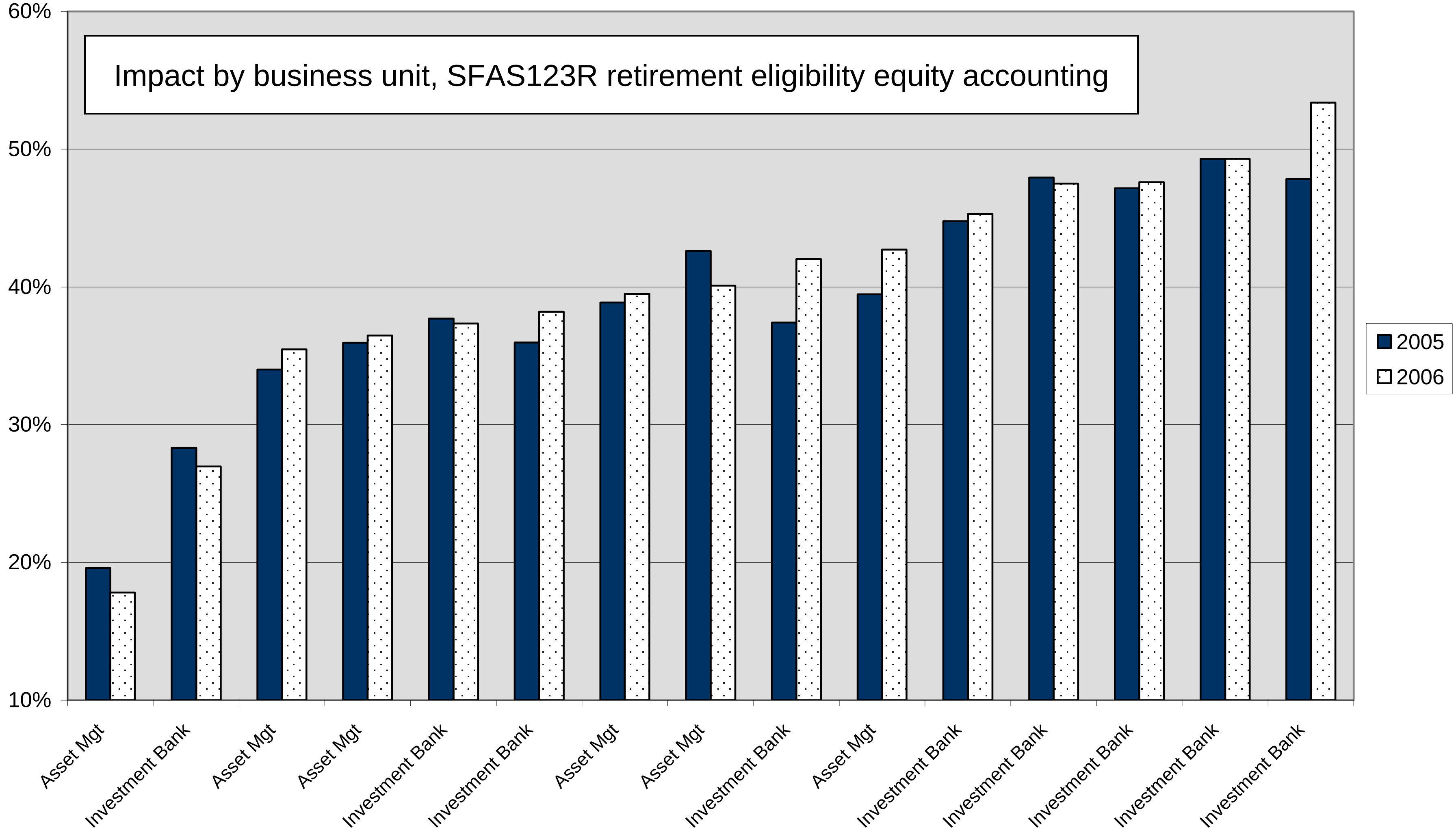
Illustration of Conflicts



2006 vs. 2005 Changes in Key Indicators

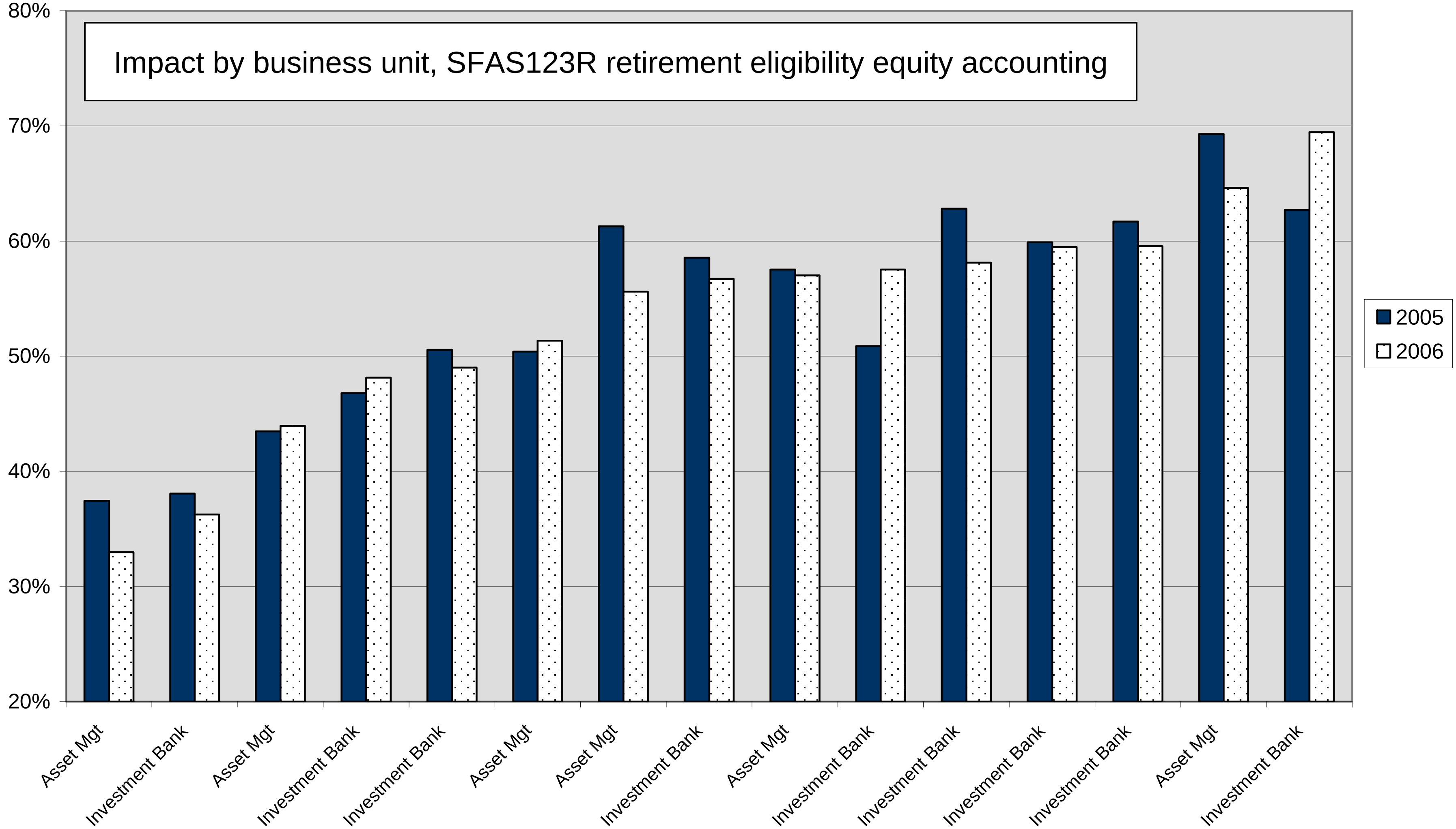


2006 vs. 2005 Compensation as % of Net Revenues



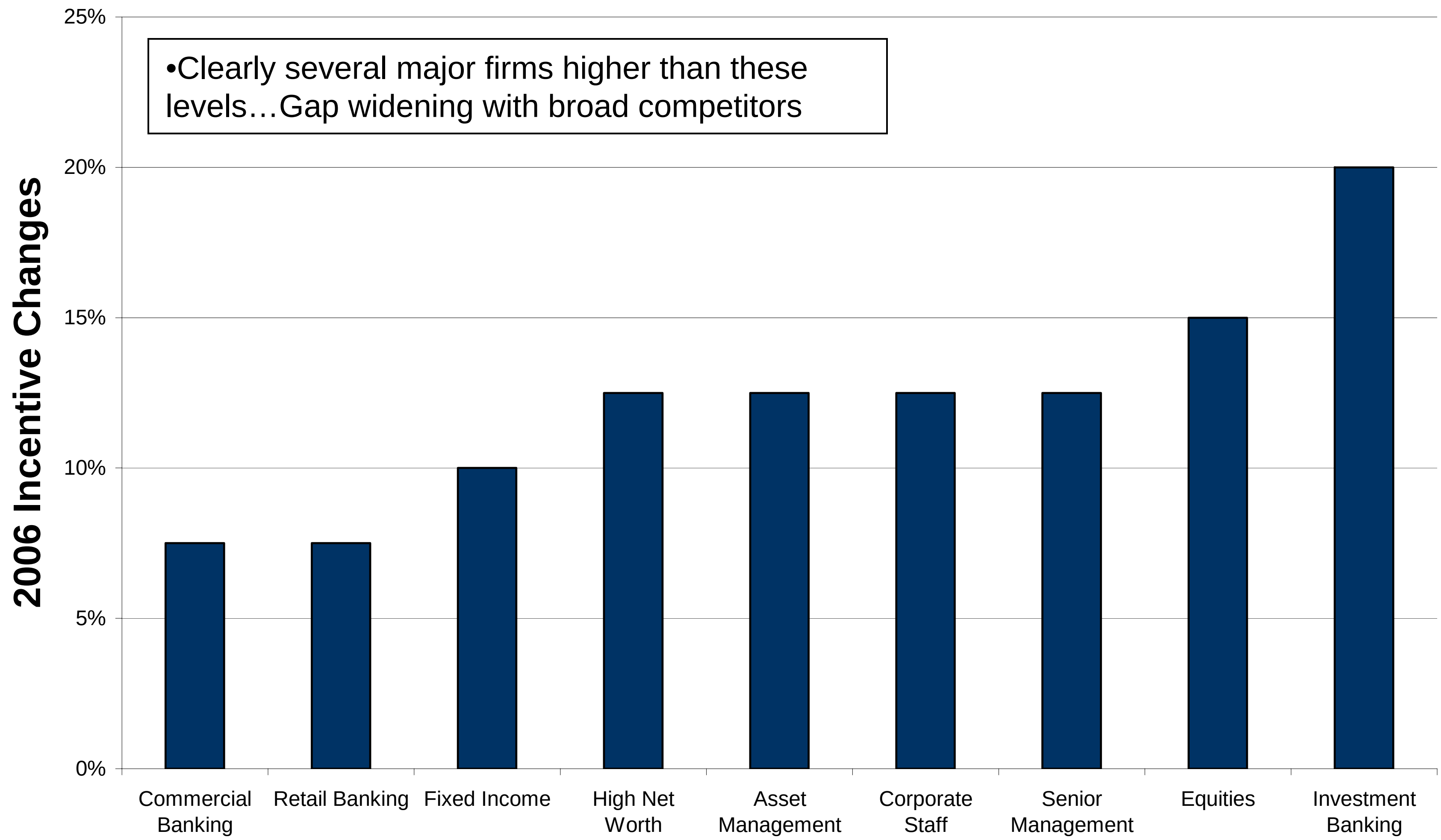
Note: Net Revenues include provision for credit losses

2006 vs. 2005 Compensation as % of Pre-Tax Pre-Comp Income



Note: Net Revenues include provision for credit losses

2006 Typical Incentive Changes (Value of Cash Bonus and Equity)



Base Salary Levels

- Industry base salary levels continue at low level
  - $\cong$ 4% increases continue as norm

- Low nominal base salaries do not automatically mean reduced fixed compensation
  - Often other elements increased or expectations established (i.e., "salary portion of bonus")

- Different market norms across businesses/units often not adequately recognized
  - Asset management and alternatives higher, along with some staff areas (i.e., technology and legal)

Long-Term Incentives

- Heavy use of restricted stock reflecting accounting advantage elimination for stock options
  - Stock settled SARs overtime replace stock options
- Heavy equity orientation program strength
  - Shareholder alignment key for senior professionals
  - To date minimized impact of ISS arbitrary guidelines
- For large diversified firms, effective single stock difficult
  - Deferrals into funds by asset management participants
  - Fund ownership by alternative professionals
- Continuing towards more sensible termination provisions
  - Leaving industry receiving more favorable treatment

Equity Alternatives Pitched by Consultants

- Considerable interest by consultants in long-term performance share programs based on growth in earnings or EPS
  - Difficult to effectively implement in evolving or changing firms
  - Appear at times to ignore practical considerations (i.e. cyclical business, acquisitions)

- Relative performance versus peer firms
  - Stock price and financials
  - Peer group composition and relevance

- Performance restricted stock
  - Earn variable number of restricted shares on absolute or relative financial results (i.e., ROE)

Executive Compensation Funding

Feature	Wall Street	Broader Financials
Performance driver	Absolute ROE	Budget and expectations
Compensation perspective	Market rate	Target level
Business unit impact	Small impact	Moderate impact
Compensation Committee latitude	Significant latitude	Moderate latitude
Peer group	Small clear peer group	Broader generalized peer group
Equity/cash mix	Heavy equity	Heavy equity

Sales Compensation

- Emphasis on sales compensation across asset gathering businesses
  - Difficulty in attracting assets in competitive market
  - Frustration by firm management as sales cycles become longer and less real understanding of driving factors
  - Less clarity on successful sales process and dynamics

- Narrow focus on “stars” makes hiring difficult and expensive
  - Little real interest in development or training programs
  - Continued compensation reductions for lower level producers

- Objective compensation continues to dominate
  - Exception is alternative products where institutional sales often discretionary and problems with formula-based compensation

Investment Banking

- 2006 compensation for senior professionals significantly higher
  - 2007 compensation will also increase significantly (i.e., 20% higher)
  - Subsidy from trading should be gone

- View businesses are "good" again for large firms even at reduced scale from peak
  - No longer enough to drive overall firm but key strategic element
  - Increasingly difficult for mid-scale firms to compete for talent

- Reached equilibrium in research
  - Two-tiered market of few visible seniors and number of lower-level. Increasingly few mid-level professionals
  - Buy-side research pays better with enhanced careers
  - Hedge funds driving compensation equation

- Meaningful hiring (i.e., 10%+) reflecting capacity constraints
  - Exaggerated compensation for attractive entry/junior professionals

Asset Management – Compensation Issues

- Trying to jam asset management into Wall Street pay and business norms creates underperformance
  - Long-tailed business with heavy mix of structured pay
- Unit senior management
  - Income based incentive with discretion
  - Budget achievement and "partner" sharing of profits common
- Sales
  - "Commission" sales plans with heavy weighting on new assets/retention
- Investment management
  - Structured and leveraged program at individual/team level focusing on multi-year returns against benchmarks and peers
  - ≅20% to recognize broader contributions and sales support
  - Deferral into funds in lieu of firm equity
- With three separate approaches difficult for institutions trying for broad incentive funding or comparability

Private Equity - Amazing Rebirth

- Increasing emphasis, from low point, on private equity and venture capital
  - Lag in compensation vis-à-vis independent competitors
  - Real and perceived conflict issues hard to overcome/ignored…but firms belatedly recognize need product for high-net worth clients and fee generation

- Long-tailed businesses and compensation
  - Appropriate carry design and governance crucial (i.e., vesting, investment and business decisions, etc.)
  - Carry at institutional firms often 10-15 points reflecting firm economics and importance of fund raising support

- Viable independent competitors drive market
  - Without perceived/real conflicts-of interest

- Scale has become <u>major</u> compensation consideration
  - Larger firms pay better/much better
  - Transparent compensation plans don't provide much cover

Hedge Funds

- Hedge funds and Fund-of-Funds have different compensations norms
  - Owners/Firm receive greater proportion of economics in F-o-Fs
  - More hierarchical structure in F-o-F, with few key professionals
  - As sector matures, compensation norms become clearer
- New issue for institutional firms is potential for hedge fund liquidity. Increases significantly pressure for professional ownership
  - Independents who increasingly provide ownership beyond founders
- Design details such as measuring results at fund/product/firm level has <u>crucial</u> impact on potential risk profile and culture
  - Need to have blend of transparency, stability, and flexibility
  - Fundamental business practices
- Non-competes and non-solicits of crucial importance
  - Need aggressive stance to protect and stabilize key professionals

Summary and Final Thoughts

- 2006 is another year of significantly increasing compensation and results
- Overly heavy mix of restricted stock will fade over time
- Conflicts will become a major issue but not on radar screen
- 2006 compensation for proxy executives up 15%
  - New proxy disclosure should not be major factor
- Aggressive sales compensation plans and expectations
  - Often efforts in real flux
- Wall Street struggling with asset management
  - Need market-based compensation and reward systems
- Hedge funds and alternatives
  - Increasing importance, but fundamental work needed on compensation and business practices
- Scale has become a major consideration
  - Across sectors and geography
  - Difficult to be “mid-sized”
- Gardening leave/non-competes should be aggressively considered
- Wall Street and financial services on clear upswing…. The future looks bright