2010 Compensation and Needed New Paradigm

Wall Street Compensation and Benefits Association

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Introduction

- Independent financial services compensation consulting. In-depth nuanced expertise and straight-forward advice. Sound practices and clear philosophy, incentive designs and goals/measures, market levels and funding, and equity/carry allocations. Impact of risk across the landscape.

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

Real Need for A New Compensation Paradigm

∴ Compensation must change to reflect new environment

- Better signal Executive Compensation (i.e., x% ROE = +/- Executive Pay)
  - Year-end uncertainty is increasingly not helpful
- Shareholders should know almost all equity awards mandated by regulators
  - Quit focusing on norms - Industry in unique spot
- Communication with directors and regulators on needed compensation
  - Regular updates with choices and consequences
- Need deferral choices beyond firm equity for diversification
  - Contingent Capital/Performance Unit
  - Alternative Investment/Asset Management
- Explain compensation ratio drivers and outcomes
  - Key decision makers often do not fully understand
- Base salaries will be higher - continuing adjustments coming

2010 Compensation Recap

- Moderately lower compensation for traditional Wall Street
  - Fixed income and equity trading down significantly from 2009 highs
  - Higher for asset and wealth management
  - Flat investment banking
  - Insurance higher

- Fragmented regulators and markets
  - U.K., E.U., U.S., Canada, Asia; all different

- Beginning of reduced capital usage
  - Impact to trading along with tighter spreads

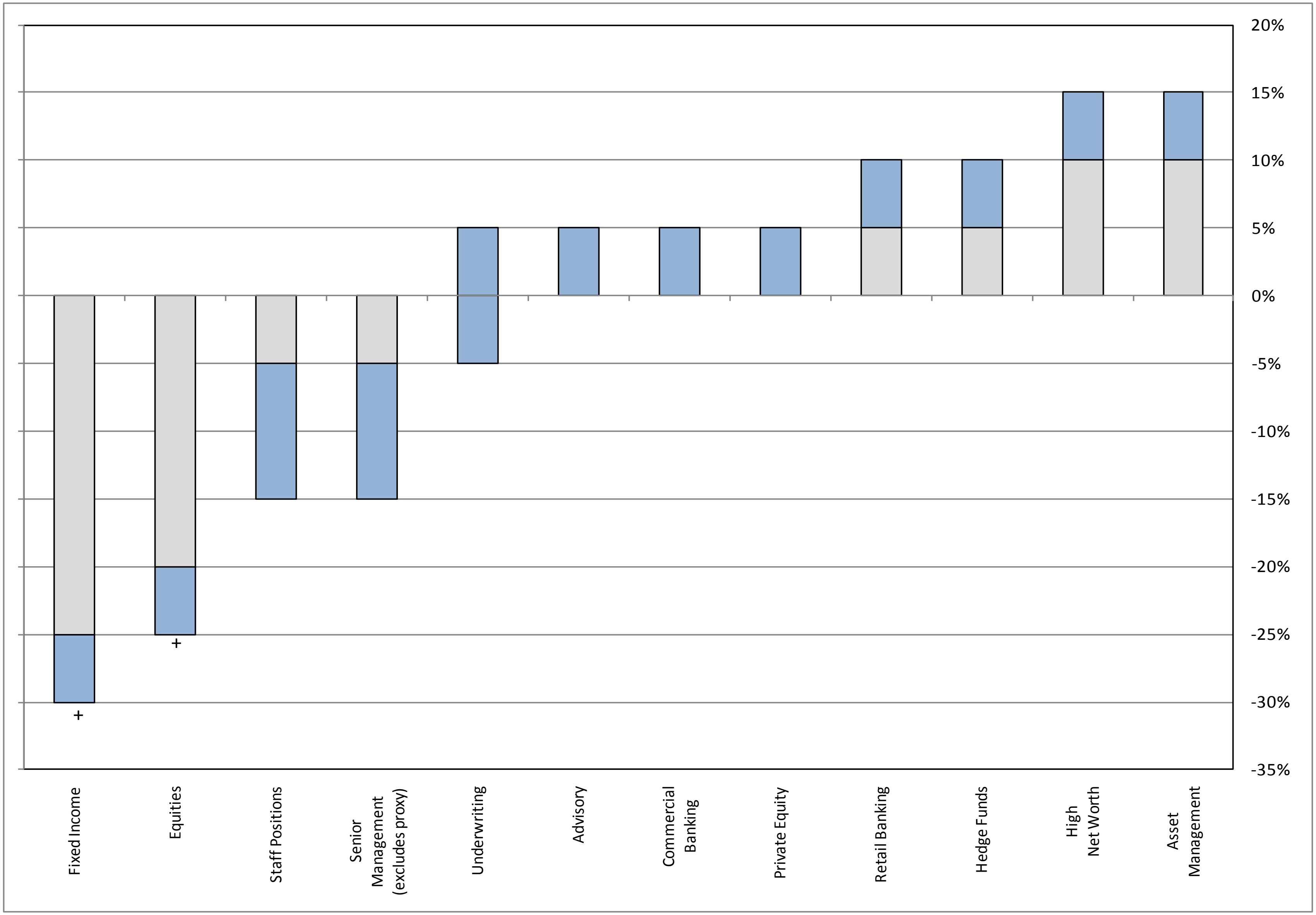
- Continued external frustration with compensation, levels/ratios
  - Less capital is de facto reduction in ratio/opportunity, but not transparent or widely understood

- Asset and wealth management up on higher AUM and returns
  - Incentives up 10%-15% and high expectations for 2011
  - Increasingly de-linked from traditional Wall Street

2010 Compensation Recap

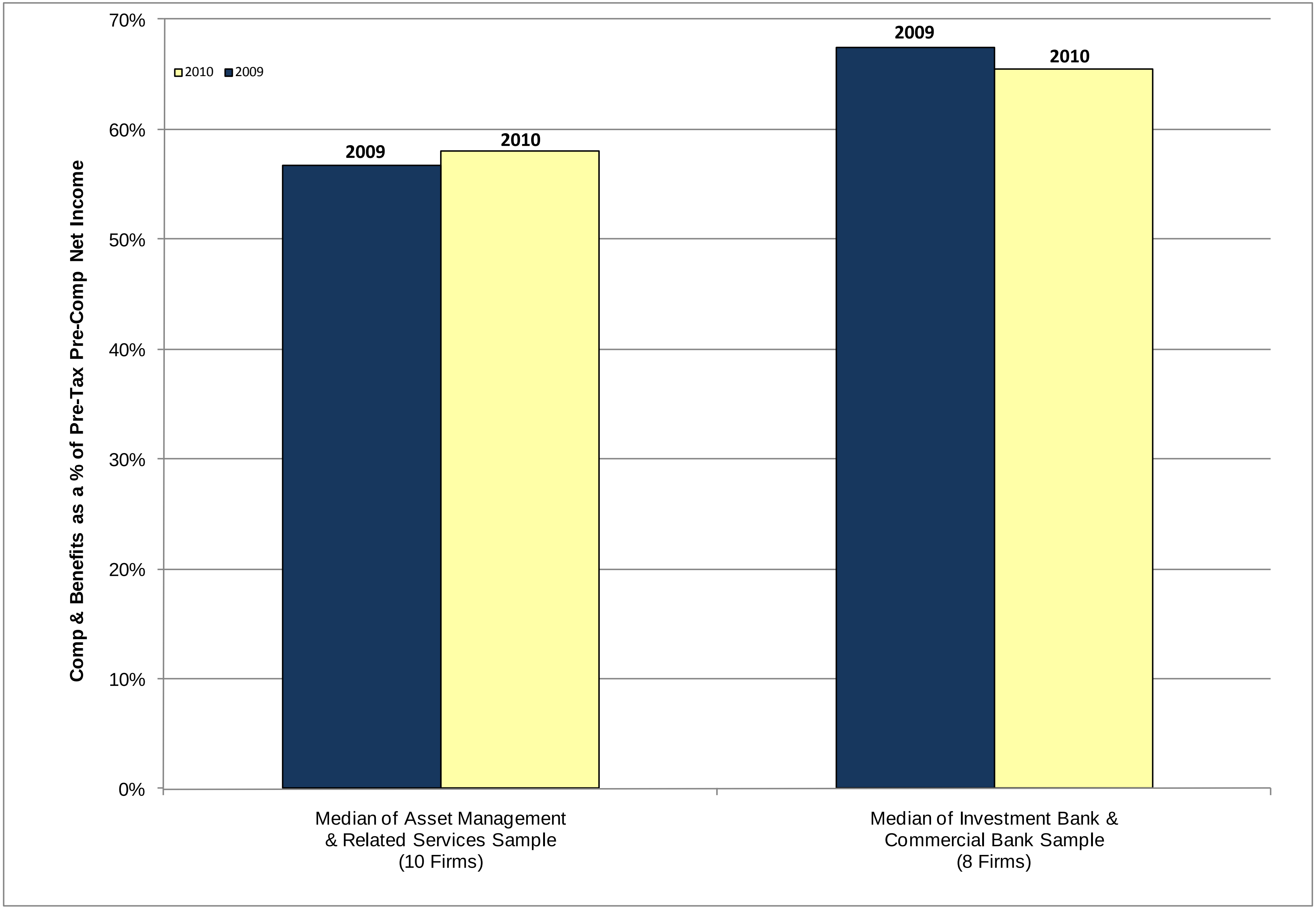
- Continued heavy focus on risk and oversight
  - Quantitative focus from models/accounting
  - Direct regulator input on designs (i.e., less leverage, more discretion, explicit consideration of risk and compliance, etc.)
- Extreme level of deferrals continues
  - Much less in boutiques, asset managers, and alternatives
  - Unintended result of increasing cost of hiring into industry, and increasing pull from other career choices
- Labor market improved during year
  - Expect continued but gradual positive direction
- Hedge funds and other alternatives positive
  - Many/most reach "high water mark"

2010 Typical Incentive Changes (Value of Cash & Equity)*

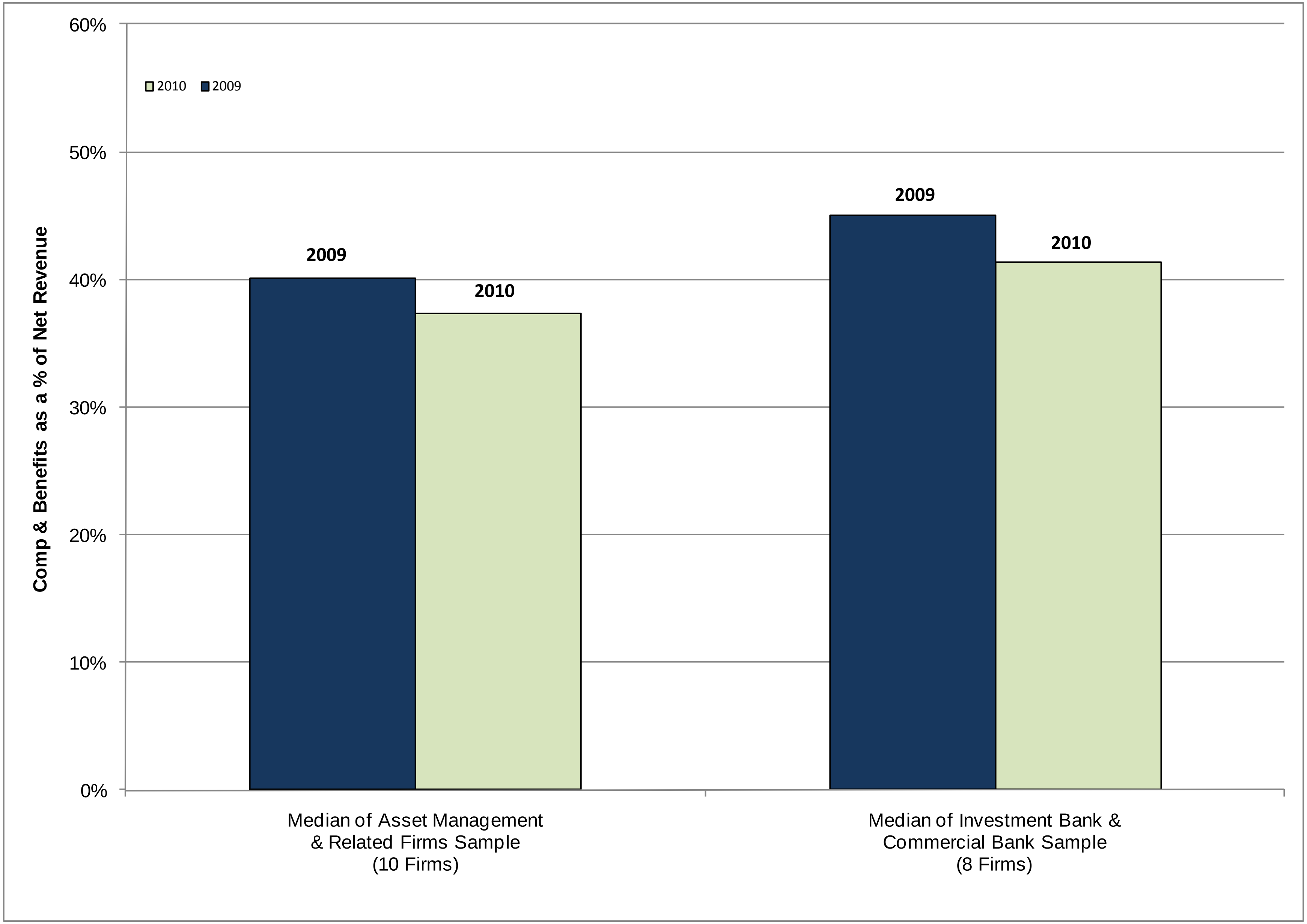


* "same store" basis

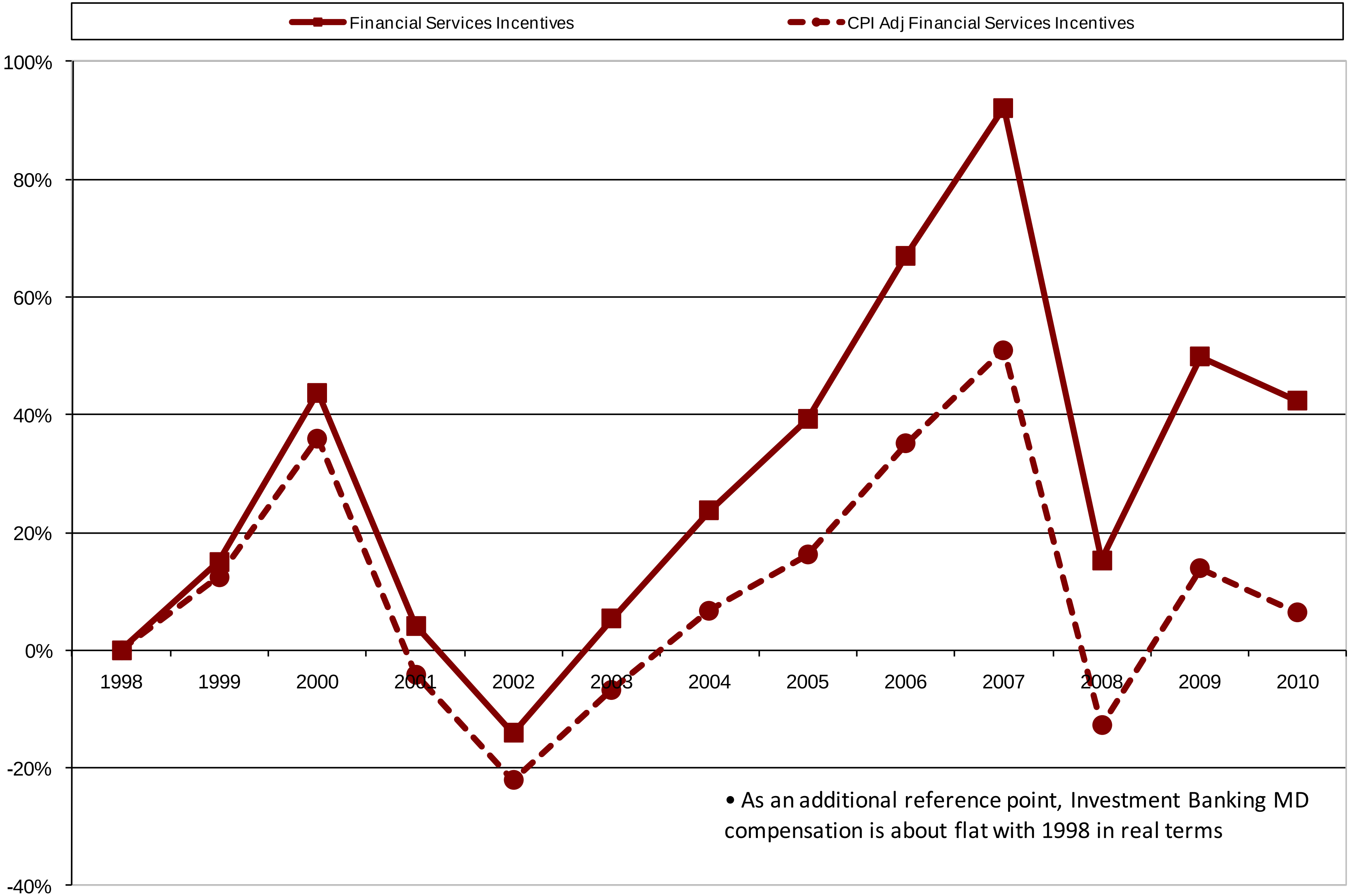
2010 vs. 2009 Compensation as % of Pre-Tax, Pre-Comp Income



2010 vs. 2009 Compensation as % of Net Revenue



Incentive Changes from 1998 – 2010



Future Dynamics and Implications of Compensation Ratio*

Expectation: Compensation Ratio will decline significantly from x% (i.e. 45%) to y% (i.e. 35%) from discipline, prudent risk taking, and exit from proprietary trading

- Achieve political mandate of reducing compensation

Ratio Reality: Compensation Ratio will increase moderately from x% (i.e. 45%) to z% (i.e. 50%) as lower payout businesses (i.e., trading) especially proprietary, are replaced with higher payout (i.e., investment banking, asset/wealth management, brokerage)

- Achieve regulatory mandate of reducing risk and focusing on customers

Potential Unintended Consequences: 1) Take less visible or traceable risks 2) Increase outsourcing to reduce ratio 3) Increase joint ventures 4) Underspend on technology and back office 5) Increase retail banking 6) Purchase an insurance company, etc.

* Recognize visible metric of industry compensation

2011 Fearless Predictions

- 2011 incentives increase moderately from 2010 (i.e., +10%-15%)
  - Fixed income and equities flat on reduced capital
  - Investment banking continues to improve
  - Commercial and retail banking moderately up from 2010
  - Asset and wealth management/brokerage up <u>significantly</u> due to AUMs

  ∴ Mix of business drives outcomes

- Reduced residential and commercial real estate issues, but crisis escalates in sovereign governments (and subunits)

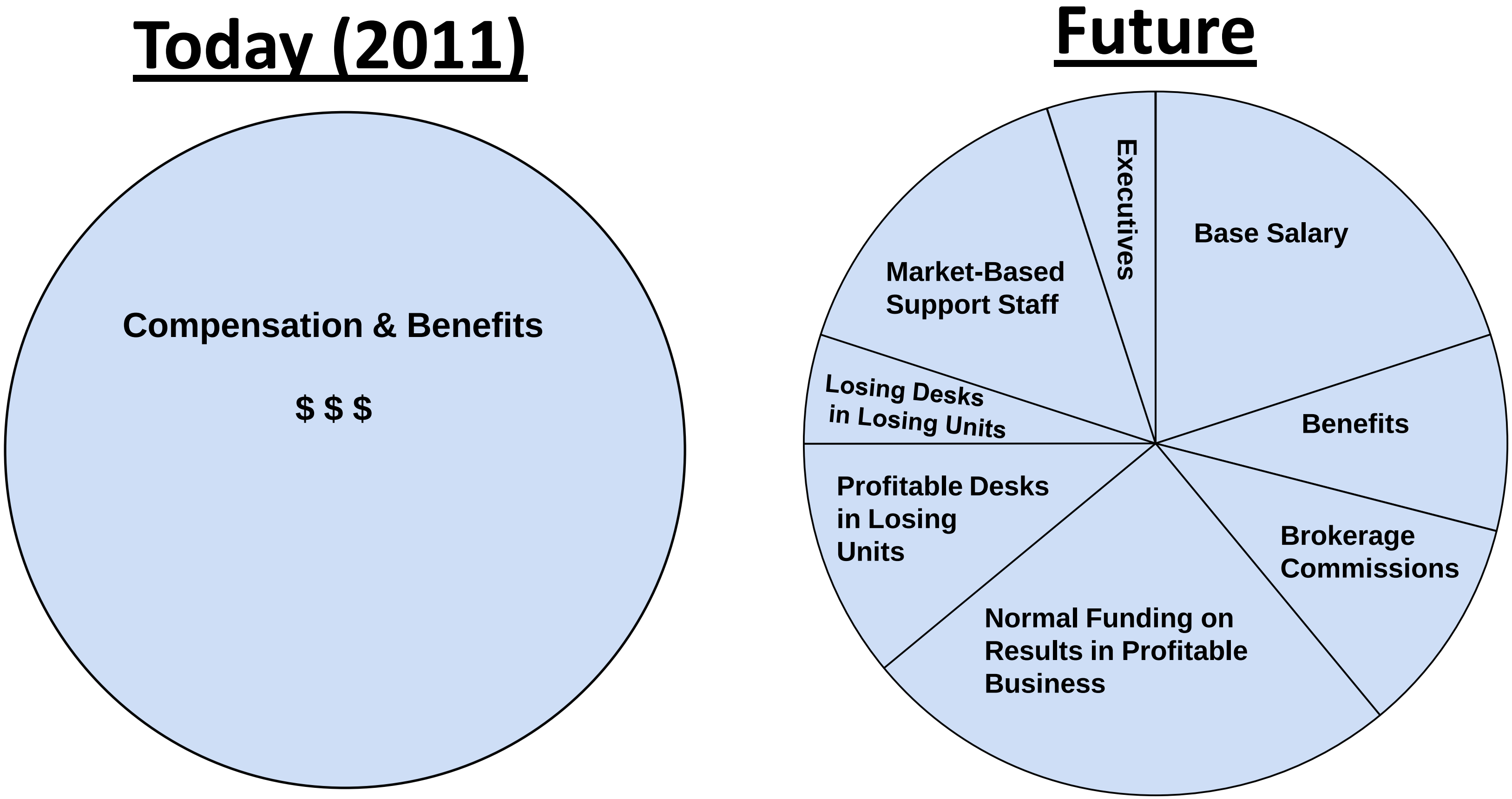
- Proxy compensation continues to market levels
  - Transition from 2008–2011
  - Many major CEOs in $13–$23 million range

- Extreme deferrals institutionalized
  - Greater utilization of asset management and alternative vehicles
  - Continued differences by geography

2011 Fearless Predictions

- Labor market issues become more significant
  - Increased difficulty and expense of external recruiting
  - Movement to other financial services firms
  - Hedge funds and private equity attractive
- Second round of base salary level adjustments at year-end
  - Regulatory pressure is intense to reduce incentives. Adjustment begins to actually increase fixed costs
- Firms rethink management structure and Chairman role (not really…but they should)
- Clawbacks put to first initial tests and found wanting
- Poor external communication of basic compensation model and magnitudes
  - Across all stakeholders

Compensation Transparency and Communication



Current model cannot be explained or justified. It is necessary to have compensation system that can be explained and defended.

Nomenclature and Context Continues to be Important

- Incentives driven by performance, markets, and competition
  - Not bonuses which imply judgmental "tips"

- Adequate/appropriate base salaries are a good thing
  - Difficult to justify unduly low salaries

- Bulk of senior professional incentives earned from continued employment and shareholder value creation

- Employee benefits and perquisites moderate compared to other high-profile industries.

Base Salary – Second Adjustment 2011 Year-End

- Initial base salary/Incentive mix change well received
  - Long overdue
  - Minimal impact on fixed costs/flexibility
  - Contemplated to be final, with modest annual changes

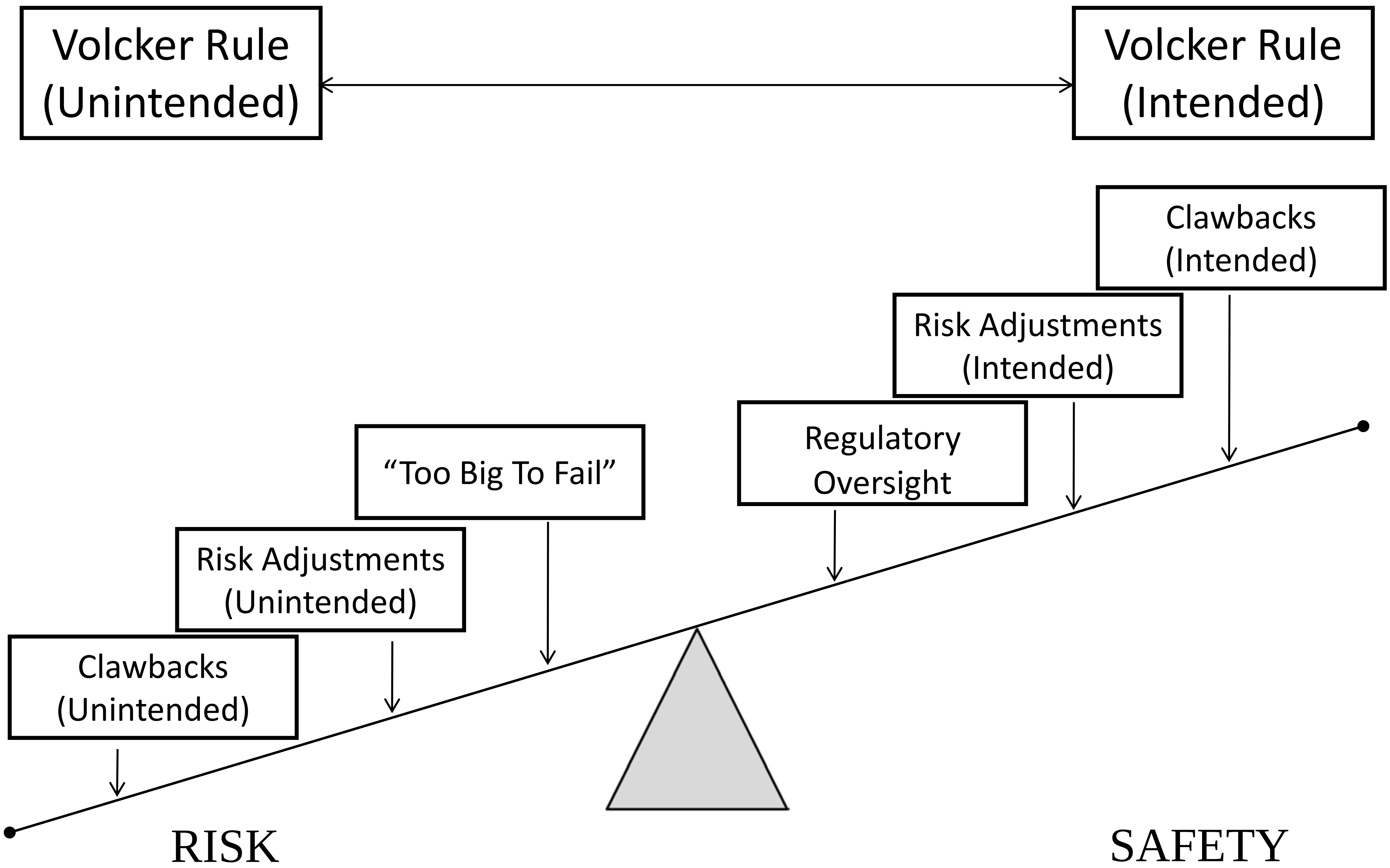
- Pressure building to reduce incentive pools and plans
  - Regulators dislike incentives and distrustful of performance
  - Direct/indirect impact on incentive funding

- Expectation for second base salary/incentive mix change
  - Year-end 2011 plus adjustment half as large as original
  - Will impact fixed costs/flexibility in down years

Clawbacks and Risk Adjustments

- Clawbacks in compensation programs
  - Appropriate for willfully violating legal or risk standards
  - Treatment of future losses difficult due to shared decision-making/selective application/documentation
  - For losses, should be carefully calibrated at higher than individual level (i.e., desk, unit, business, or firm)
- Threat of clawback actually increases major risks
  - Individual subject to clawback become unemployable
  - Little incentive to self report medium to large problems
  - Incentive to "double down"
- Risk adjustments rely on modeling and accounting
  - Recognize hard to measure "before the fact"

Cross Currents on Risk Become Evident



Executive Compensation

- 2010 – 2011 continues movement to market levels
  - Executive view: market compensation for market performance
  - Appropriately ≅15% ROE produces lower pay than 25% ROE during boom
  - New CEO normal for large banks ≅$13-$23 million

- Need to manage external expectations continues
  - New disclosed Citigroup executive formula (ex-CEO) helps establish link between pay and performance

- Need significant ownership guidelines
  - Both active and for two years beyond termination

Potential Forms of Deferral

- Extreme deferral rates established/no longer surprising
  - Within regulatory constraints need choices to firm equity
- Increasingly puts industry in disadvantageous position
  - Many financial service firms do <u>not</u> have same deferral requirements <u>or</u> sole focus on firm stock.
- Recognize solutions nuanced by professional group
  - More equity for executives, different mix for others
- Range of potential choices (all with issues)
  - Firm equity
  - Contingent capital/return units
  - Firm investment (i.e., hedge funds, private equity, real estate, etc.)
  - Asset management portfolios
  - Cash/low risk deferrals

Investment Banking

- 2011 should be better than disappointing 2010
  - Pipeline has slowly improved
  - Fee businesses more attractive with capital constraints
  - Moderately sized business for most firms
  - Expectation of at least moderate profitability

- More focus on research
  - Need more senior professionals
  - Buy-side research compensation increasing
  - Hedge funds back into market

- Staff size steady

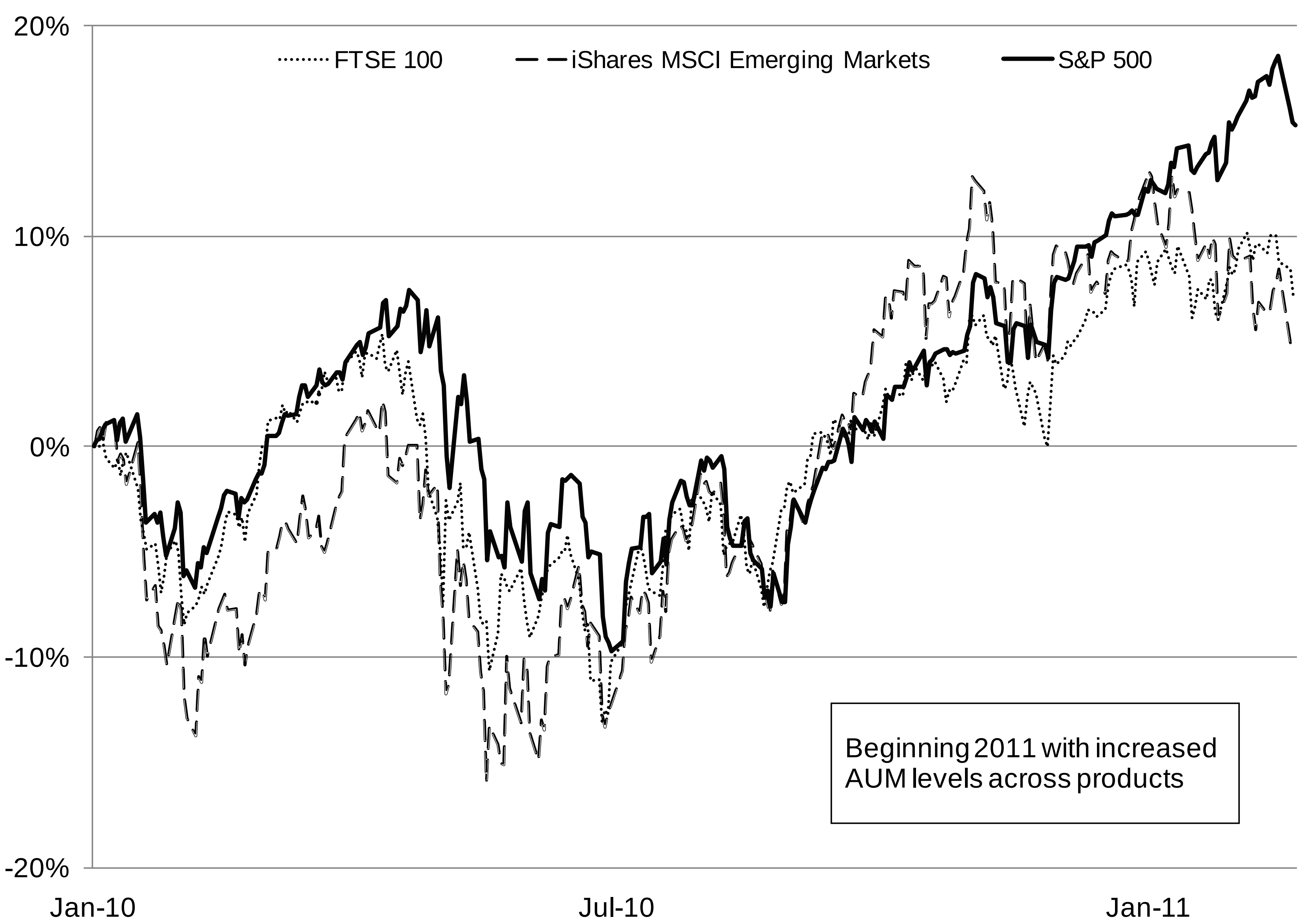
Asset and Wealth Management

- Increase in 2011 revenues drives major incentive increase
  - Up 20% from 2010 (which was up 15% from 2009)

- Real growth area needs different approach (expectation of investors and their advisors
  - Long-tailed business with heavy mix of structured pay
  - Pre-agreed % of operating profit for incentives
  - Often structured program at individual-/team-level on multi-year returns against benchmarks and peers
  - Deferral into funds in lieu of firm equity

- More subsidiary equity programs required
  - Investor and consultant requirements
  - Lure of independent firms

Impact of Market on AUM Businesses



Hedge Funds – Rapid Recovery

- Hedge Fund had solid 2010
  - Many/most have recovered to “high water mark”
  - Industry assets recovered
  - More fee pressures

- Benefitting from issues with major banks
  - Regulators/Dodd-Frank/Volcker rule
  - Heavy deferrals

- Potential compensation offering
  - Objective focused compensation
  - Moderate deferrals into funds
  - Less risk of clawbacks
  - Ownership potential

Private Equity – Continuing Improvement

- Industry in rebound
  - 2008-2010 investments promising
  - Benefitted greatly from investors searching for returns

- Long-tailed businesses and compensation
  - Appropriate carry design and governance crucial (i.e., vesting, investment and business decisions, etc.)
  - Progressive carry at institutional firms 10-15 points (out of 20), reflecting firm economics and fundraising support

- Viable independent competitors drive market
  - Fund sizes provide ample compensation resources

- Low interest rates and poor equity returns elsewhere have helped greatly
  - Investors continue to look to alternatives for needed returns

- **Continued improvement in fundamentals plus luck (Dodd-Frank/Volcker), project better prospects than 12-18 months ago**

Summary and Advice

- 2011 compensation will be up moderately for most firms
  - Trading flat on less capital
  - Investment banking improves moderately
  - Commercial and retail banking up as losses moderate
  - Asset and wealth management/brokerage up significantly
- New paradigm/reality needed
  - Better signal of executive compensation
  - Recognize equity/deferrals driven by regulator mandates
  - Improved communication with directors/regulators on needed spend
  - Need deferral choices
  - Compensation ratio drives need for greater transparency
  - Second base salary/incentive mix change coming
- Real competitors for talent
  - Geography
  - Other financial services/boutiques
  - Hedge funds
  - Private equity

∴ ***Industry must improve quality of dialogue on compensation programs, and then effectively communicate. Audiences are external, internal, and Compensation Committee/Board of Directors***