2012 Financial Services Compensation:

Ongoing Struggle and Future Opportunities

PRESENTATION AND DISCUSSION

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- Independent financial services compensation consulting firm. Tailored advice, annual and long-term incentive designs, market data and levels, agreements, and goals/metrics. Equity, ownership, and partnerships. In-depth knowledge across comparators, labor markets, and political/social considerations
  - Experienced, opinionated and informed
  - Both Board consultant and company programs

- Diverse clients and issues
  - Universal and major banks
  - Asset Management firms
  - Hedge Funds/Private Equity/Fund-of-Funds/Alternatives
  - Insurance companies
  - Brokerage firms
  - Trading organizations

2012 Year-End: Industry Sectors & Areas

- For 2012, slight increase in incentive funding by sector and area
  - Major Investment and Commercial Banks (i.e., -5% to +5%) helped by Fixed-income (i.e. +10% to +20%), Commercial Banking (i.e., 0%-10%), Investment Banking (i.e., -10 to +5%), and Wealth/Asset Management (i.e., 0% to +10%). Equities continues to disappoint (-5% to -10%+).
  - Market-based business up slightly over 2011. Asset/Wealth Management (i.e., +5% to -5%), Hedge Funds (i.e., flat to +5%) and Private Equity (i.e., flat to +5%)

- Industry resizing continues
  - Capacity reductions
  - Strategic changes continue in 2013

- Challenging to manage expectations, decipher market trends and recognize performance

- Noticeable compensation variations between U.S. and European firms
  - U.S. Firms generally better than European Banks more intertwined with Euro situations

- Modest retention concerns into at least mid-2013
  - Disappointing labor market continues

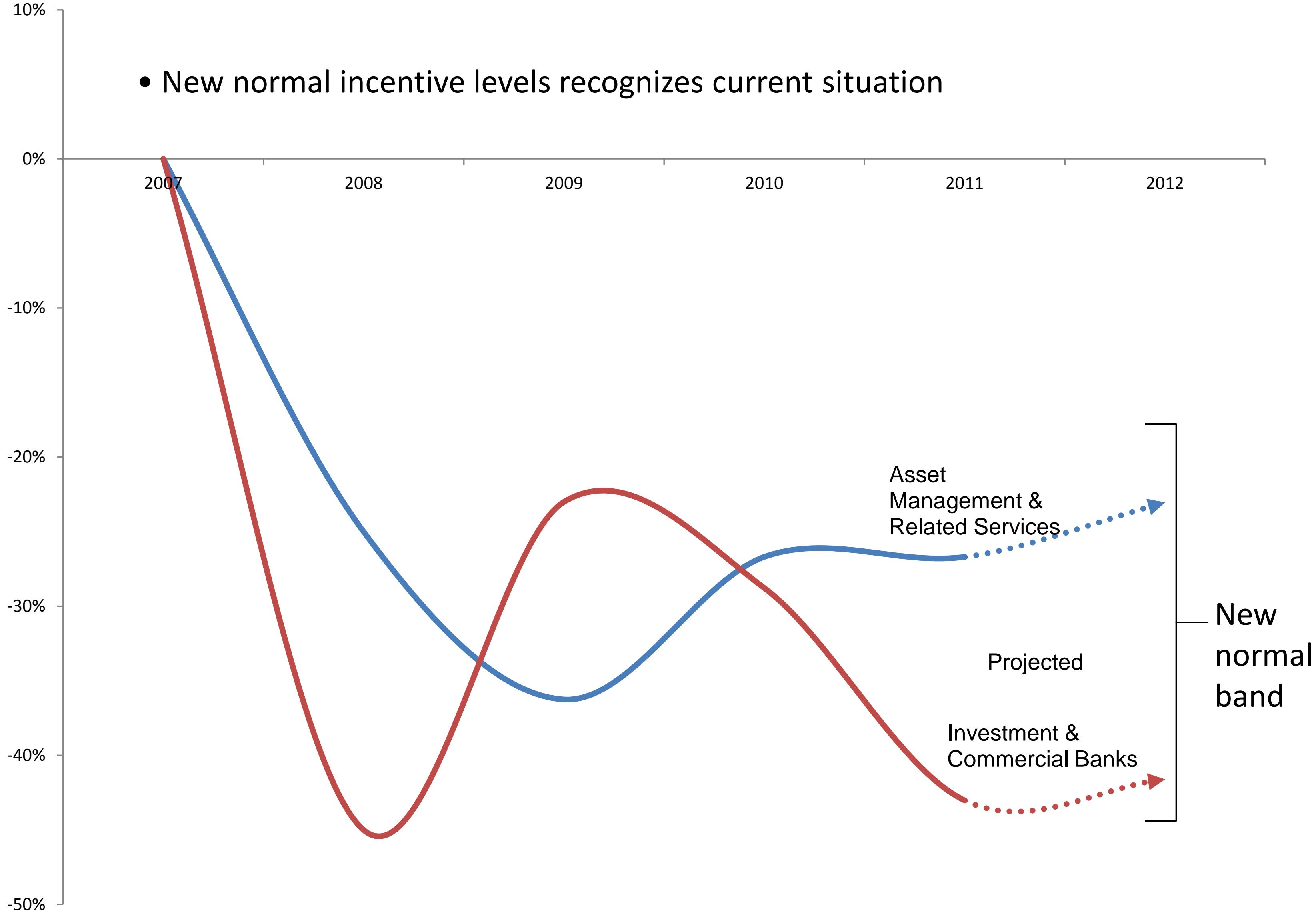
- Very heavy Wall Street deferrals continue with some variations by region
  - Provides competitive advantage for those with lower deferrals

Different Compensation Paradigm Going Forward

- Continuing scrutiny of executive compensation levels
  - Vis-à-vis market, other industries, and " what feels right"
- More difficult to sustain businesses in slow periods
  - Less understanding/patience with industry cycles
- Continued view financial services compensation far exceeds real market
  - Few alternatives perceived for industry professionals
- Increasing complexity of compensation delivery
  - Multi-year performance objectives
  - Relative shareholder return as measures
- More use of targets/compensation caps for executives
  - Can align with financial expectations
  - Today less need for totally discretionary approach

∴ ***Firms will increasingly manage compensation and other expenses to achieve short-term financial results. Favors specialization, flexibility, and leaner staffing.***

Incentive Trends Reflect Stalled Markets



Continued Impact of Regulation & Environment

- Fundamental lesson: political process with asymmetrical motivations
  - Emphasis by geography continues (Asia/Latin America a “winner,” NY/London “losers”)
  - Assumption major mistakes can usually be linked directly to individual
- Regulation includes more than significant risk-takers/delves deeper into organization
- Base salary and benefit levels are not regulated
  - Fixed elements considered positive
- Reliance on accounting/models to capture risk continues
- Compensation Committees impatient – Impact of regulators, shareholder, and ISS
- Broad incentives should be funded formulaically, including cost of capital
  - Allocations subjective but should be able to be calculated
- Environment negative to Wall Street compensation
  - Symbol of inequality and greed

∴ ***Increasing expectation compensation should move directly with earnings. Increases importance of fee-driven businesses such as asset/wealth management, retail brokerage and banking, and specialized lending***

Compensation Regulation – Status Quo

<table>
<tr><td>Federal Reserve</td><td><u>Risk</u>
• Charge for liquidity risk for internal profit measures viewed favorably

<u>Risk Assessment</u>
• Quantitative risk measures preferred, however recognizes very difficult to implement. Judgment-based decisions continue to be more prevalent

<u>Deferral Latitude</u>
• Does <u>not</u> : (i) require for all employees, (ii) suggest formula, (iii) mandate specific vehicle

<u>More Performance-Based Deferrals</u>
• Prefers performance-based deferral to more employees

<u>Interaction between Committees</u>
• Increase communication between compensation committee and risk/audit committees</td></tr>
<tr><td>Dodd-Frank</td><td>• Broadly defines and bans proprietary trading by banks with FDIC, limiting investments in a hedge or private equity fund, and require banks to install internal controls for compliance

• Rule exempts trades related to market-making as long as the activity met at least seven standards, or principles. One principle traders paid from fees and spread of transactions only

• Final rules and implementation still pending</td></tr>
<tr><td>Directional Impact</td><td>• Higher levels of covered employees
• Structured compensation programs (i.e., targets, caps, etc.)
• Less emphasis on ownership</td></tr>
</table>

Lessons & Impact of Shareholder Advisors*

- Discourages being outside norms
  - Firms in difficulty/new management further disadvantaged
  - Cannot satisfy everyone

- Heightened impact of weak/nervous Directors
  - Desire to please/not stick out

- Recognize "hot buttons" and "easy fixes"
  - Excessive contracts
  - Tax gross-ups
  - Weak clawbacks
  - Perquisites
  - Lack of performance-based long-term

- Lessons
  - ISS poor quality is a given. No guiding principles and evolving guidelines. Always needs major firms to fail to maintain business model
  - Failing the vote <u>is</u> a big deal with ramifications
  - Important to engage major shareholders early
  - Compromises and/or creativity can lead to decent outcomes

* Past time to endlessly criticize roles of ISS/Glass Lewis. While sad indictment on many levels, not going away

Long-term Performance Equity/Plans

- Movement both within financial services and broader industry towards performance features incorporated in long-term awards. Key is to begin with executives, and then decide if concept makes sense for other senior professionals
  - Increased complexity / pressure on goal setting and peer groups, and perhaps less alignment with other professionals

Past Approach (1-2) vehicles
- Time-based restricted stock
- Performance plans (i.e., ROE over 3-years)
  - 0-200% target

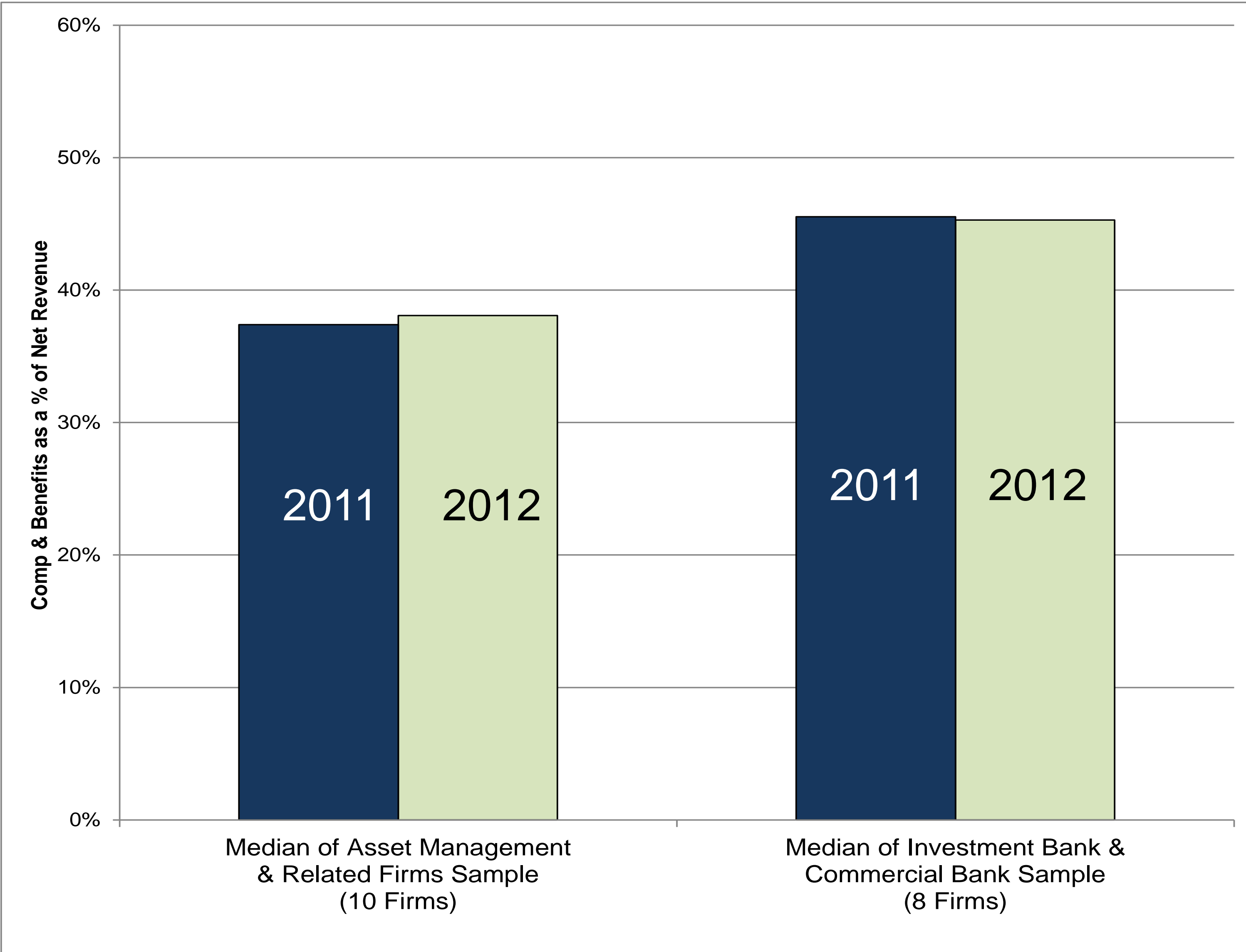
Current/Evolving Approach (2-3 vehicles)
- Time-based restricted stock
- Performance plans (i.e., ROE over 3-years)
  - 0-200% target
- Performance-earned Restricted Stock
  - 3-5 Years
  - Relative shareholder return/ROE
  - 0-200% target

2013 Fearless Predictions: Moderate Recovery Continues

- Asset/wealth management, insurance, and alternatives stronger in 2013 (i.e. +10%+)
  - Lag effect of AUM and equity valuations moves compensation
  - Efforts to reduce costs to reflect 2013-2014 size expectations
- Investment/commercial banks higher (i.e., +15%)
  - Fixed Income continues to improve. Equities better on smaller capital
  - Investment Banking and Asset Management up moderately
  - Impact of cost cutting and strategic exits becomes apparent
- Regulatory/political directions further Asian/emerging markets movement and expansion
  - Divergence in results continues between U.S. and European firms
- Intermediate prospects clouded by next major storm
  - Inability to pay government-sponsored entitlements
  - Scenario: If major country fails, directly impacts compensation environment
- Firms continue to become leaner in challenging revenue environment
  - Both significant headcount reductions and strategic exits

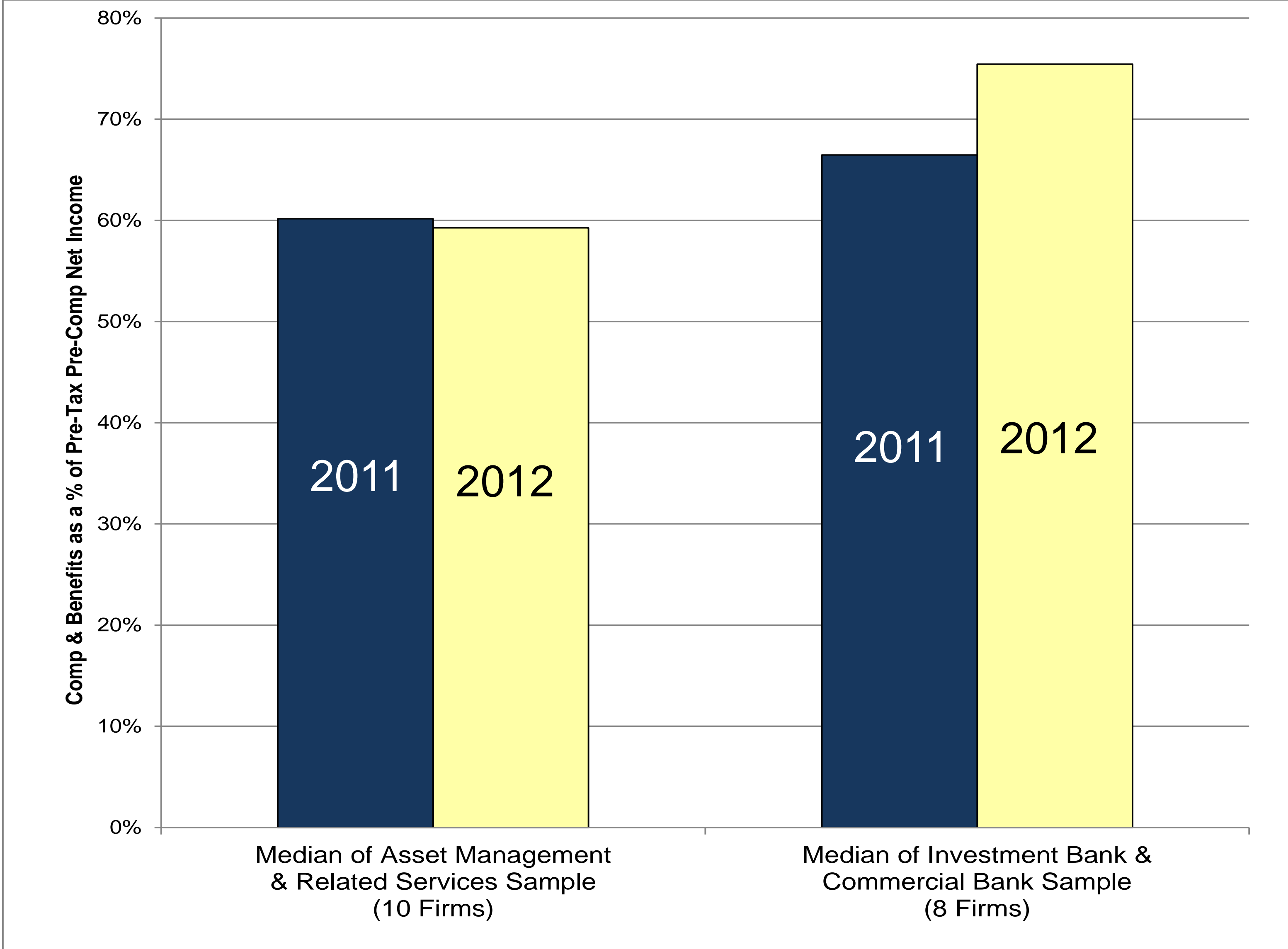
2012 vs. 2011 Compensation as % of Net Revenues

Note: Reflects available year-to-date data

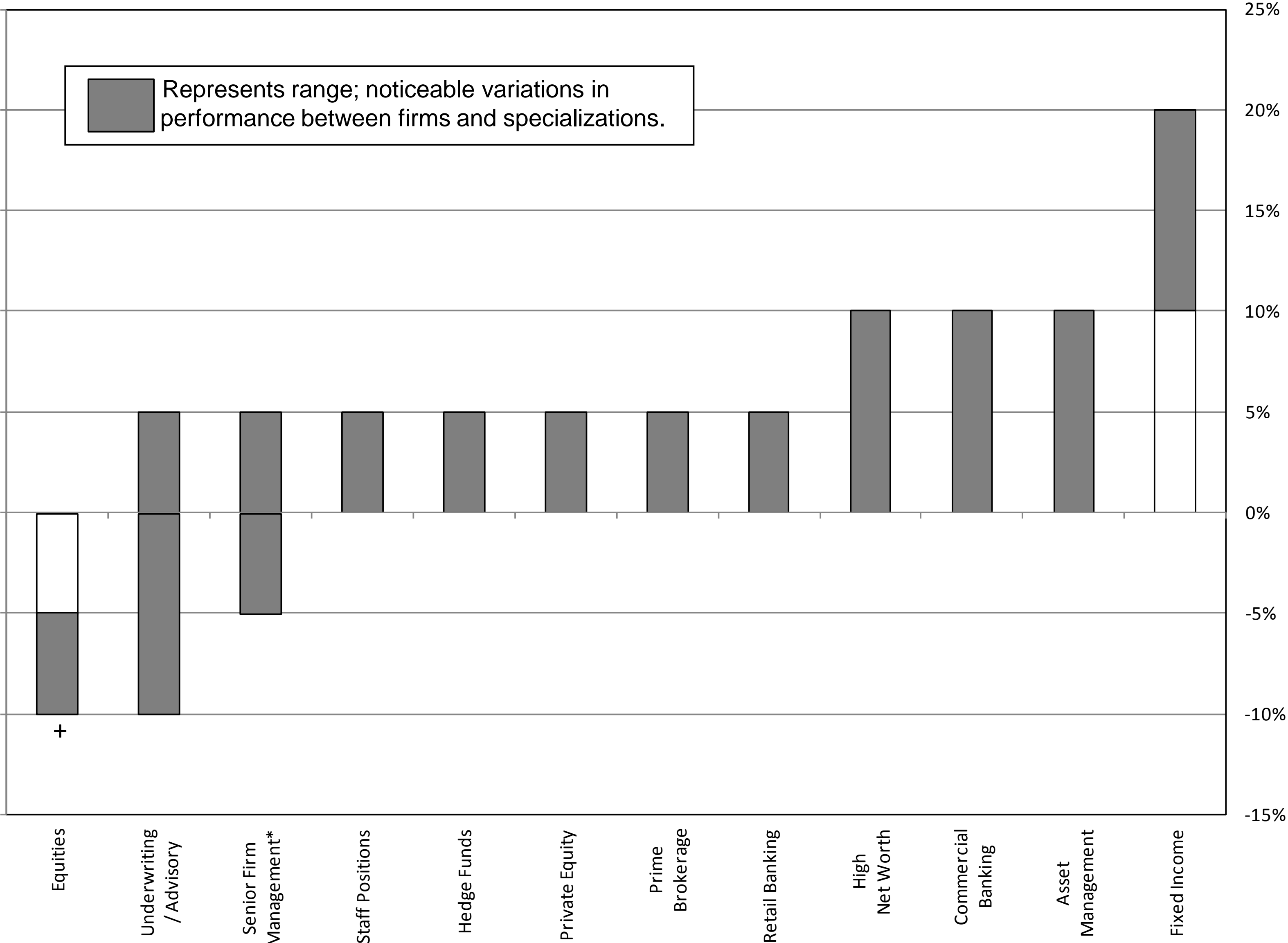


2012 vs. 2011 Compensation as % of Pre-Tax, Pre-Comp Income

Note: Reflects available year-to-date data

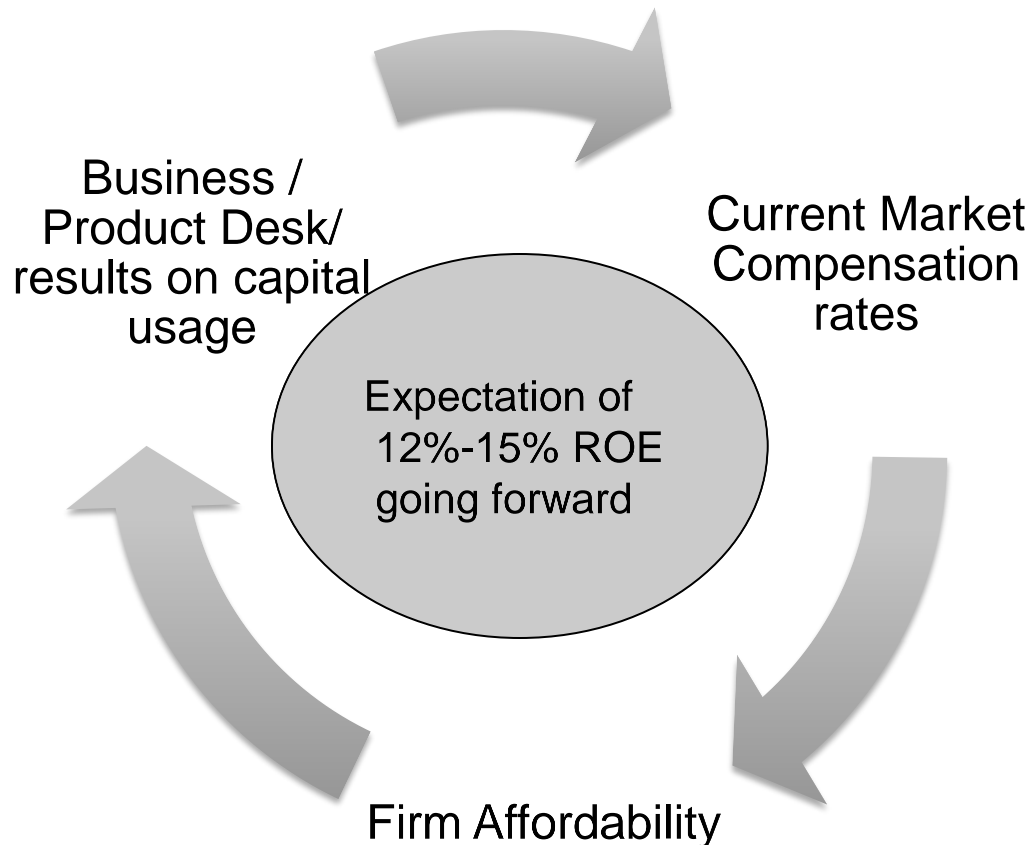


2012 Typical Incentive Changes (Value of Cash & Equity)



*Excludes proxy executives impacted by firm specific circumstances

Incentive Designs and Constraints – 2012 and Going Forward



∴ ***While elements not new, heightened process creates increased uncertainty regarding available funding. Advantage gained by firms and professionals who have a longer-term perspective and consistent profitability***

2012 Executive Compensation Considerations

- Flat level of executive incentives broadly
  - Firm by firm variations
  - View senior management moves with other professionals
- Overall compensation is roughly consistent with performance
  - "So-so" results with "so-so" pay. Better link than in 2010-2011
  - Current pay bands for executives more in line with other industries than 2006-2007 or 2009 market high points
- Common view executives should increase/decrease with earnings
  - Requires considering multi-year scenarios since starting point for compensation is important

Base Salary: Equilibrium Continues

- Moderate salary budget (i.e., 3 – 3.2%) off moderate levels
  - Salary budget has less meaning due to currencies, global markets, alternative work arrangements, etc.

- Conflicting perspectives
  - Maintain significant compensation flexibility
  - Reduce needed incentive funding
  - Limit add on benefit costs

- In major banks base salary equilibrium
  - Currently little impetus for asset managers / regional firms to raise salaries

Sales Compensation Directions

- Emphasis on sales compensation across businesses continues
  - Consistent resources across longer sales cycles
  - Retention key in a difficult environment
- Recognize potential misalignment between sales funding and overall firm
  - Higher objective compensation, less socialistic
  - Cost of doing business
- Pressure for nuanced results
  - Appropriate products
  - Client retention
  - Team efforts
  - New clients
  - Multiple products by client
- Performance differentiation increasingly important
  - Real movements towards shifting grids/payouts from bottom to top

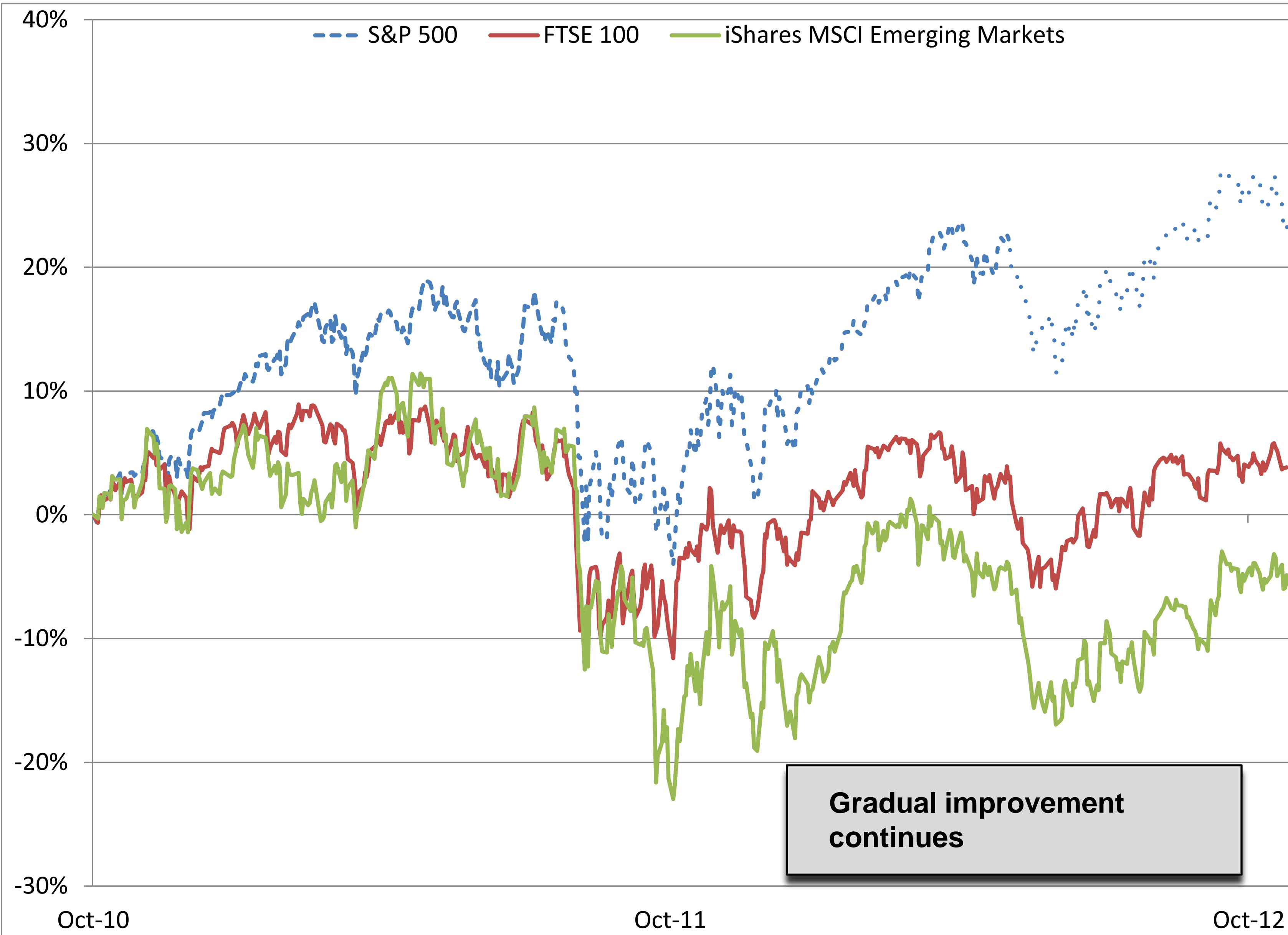
∴ ***Must have competitive advantage in terms of product, returns, reputation, or relationships. Involvement of senior management often key***

Asset & Wealth Management

- Credible year considering market turmoil/uncertainty
  - Difficult business to understand for many parent companies
- Increasingly competitive, given focus on less capital-intensive businesses
- Objective pay model common and workable
  - Pre-agreed % of operating profit for incentives
- “Commission” sales plans with weighting on new assets/retention
- Investment professionals
  - Generally objective and leveraged program on multi-year benchmarks
  - ≅ 20% for broader contributions (i.e., involvement in selling, management, product development, etc.)
  - More pressure to defer in own products (i.e., “eat your own cooking...”)
- Independent firms have smaller deferrals and less regulatory intrusion
  - Competitive advantage vis-à-vis major banks

∴ ***2013 will benefit from AUM growth and increasing investor confidence***

Asset Management



Private Equity: Optimism Continues

- Recent vintages positive (2009-2012)
  - Clients remain committed- sustained AUMs

- Longer-term business focused on carry
  - More to top professionals; few/key people
  - Longer vesting
  - Improved terms for firm protection: clawbacks/non-competes
  - At captives, often 10-12 pts. in aggregate

- Scale a <u>major</u> pay consideration
  - Allowing the largest firms to outspend for talent
  - Dodd-Frank in U.S. pushes business away from banks

- **Consensus global opportunities exist, driven by investing skill rather than pure emerging markets play**

Hedge Funds: Institutional vs. Boutique Models

- Tale of two perspectives: Institutional vs. boutique
  - Institutional attempts to create sustainable platform that is scalable and value based. Elements include ownership/partnership, deferrals, and non-competes/non-solicits, etc.
  - Boutique attempts to generate investor returns on a narrow platform, often not scalable and current income based. Focus on current income and less on ownership or transition

∴ ***Competing data on hedge fund practices may not recognize really different perspectives and paths between two firm types***

- With oversight and regulations, incentive design details receive more focus
  - Risk profile
  - Alignment to both portfolio and firm

- Quick Equity Design Checklist:

  - Timeliness
  - Pricing and Valuation
  - Amount
  - Participation
  - Permanent/Expires
  - “Stock”/”Options”/Combination
  - Vesting
  - Non-Competes
  - Change-in-Control/Severance
  - Transition/Multigenerational

Director Role and Pay Implications

- Increased time commitments, complex issues and new legislation/ regulation evident
  - Pressure for increased accountability
  - Unprecedented scrutiny of pay designs and magnitudes

- "Say on Pay" increases pressure
  - Highlights impact of weak/nervous Directors

- Transparency and proactive communication between Boards and management
  - Crucial importance of open communication
  - Boards retain discretion on payouts

- While requirements increased, compensation growth slowed
  - Consistent with declines for management and employees

- Sense of fatigue pervasive
  - After 4-5 years inpatient with both financial and compensation process

- Meaningful compensation changes needed
  - Major Committee heads not paid enough vis-à-vis other directors
  - Need more expertise on Compensation Committee (i.e., Human Resources)

Compensation Communication

- **<u>Few understand</u> impact corporate and business performance on pay within financial services**
- **Important to address moving forward and find a <u>more effective</u> communication approach**

- Lack of large institutional shareholders understanding surprising
  - Impact of performance seen as a binary decision point
    - Perform well → paid
    - Perform subpar → no incentive
  - In reality, a wider range of payment scenarios for performance

- Increasing concern for incentive payments with mediocre financial results
  - While firms focused on business performance, incorporate judgment and discretion in practice

- Improved shareholder outreach and more straightforward / focused compensation disclosures helpful

- For professionals important to communicate firm performance quarterly to manage expectations

Summary and Final Thoughts

- Financial services landscape gradually firming
  - General economy remains weak
  - Resizing to fit current/intermediate term revenue opportunities (i.e. making the factory smaller)

- Compensation results clearly mixed for 2012
  - Some differences by business: Wall Street vs. Asset Management and Alternatives
  - “So-So” performance results in “so-so” pay by historical standards

- Retention concerns modest for at least first half of 2013

- Heavy deferrals continue
  - Must be more creative; professionals do <u>not</u> always want all stock

- Particularly in Europe, many disappointed the perceived overall pay paradigm has not changed enough
  - Risk and capital charges difficult to formulaically build into program
  - Much self inflicted through poor communications

- If catastrophic event, there will be great pressure to not pay incentives to anyone

- 2013 will continue to get better as the industry gets leaner, and more focused