Challenging & Uncertain Compensation Landscape for Financial Firms:

Year-End 2008
& Continuing 2009 Hangover

Presentation and Discussion

October 27, 2008

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Introduction

Johnson Associates

- Independent compensation consulting firm for financial services. Pure advice, annual and long-term incentive designs, market levels, agreements, and goals/measures. Equity and partnership considerations. Expertise and in-depth knowledge across comparator groups and labor markets
  - Experienced, opinionated and informed

- Diverse Clients
  - Universal and major banks
  - Asset management firms
  - Hedge funds/Private Equity/Fund-of-Funds/Alternatives
  - Insurance companies
  - Brokerage firms
  - Trading organizations

2008 Year-End: Unprecedented Stress & Uncertainty

- Breathtaking collapse of major financial firms
  - Out-of-business/life support/government investment
  - Likely years of government involvement
  - Remaining shaky real capital structures

- Combination of credit crisis and weakening business unit results
  - Write-offs to date <u>plus</u> $600+ billion yet to come
  - Cyclical downturn across businesses with overcapacity
  - Investment banking and fixed income down significantly
  - Asset management impacted hard by stock market levels
  - Equities varies widely by firm

- Intentional weakening of mark-to-mark accounting by regulators
  - Balancing accounting legitimacy vs. need for higher disclosed equity levels
  - Performance comparisons even more difficult/impossible

2008 Year-End: Unprecedented Stress & Uncertainty

- Aggregate compensation propped up by "special situations"
  - Mergers and bailouts keep pay higher than otherwise
  - Frustrating for relatively healthy firms
- Extreme pressure to minimize CEO and proxy pay
  - Political pressure to "behave" paramount
- Heavy 2007 deferral schedules remain for 2008
  - Retention and rolling accounting charge into future
- Compensation accruals detached from overall Firm results
- Heavy restricted stock use continues
  - Little appetite for upside today
  - Volatility drives up accounting cost of stock options
- Hedge fund bubble bursts
  - Poor returns and "high-water mark" problems
  - Less leverage available going forward

P.C. Governance Helped Cause Crisis

- Recognize rush for pure objectivity in executive and senior professional pay pushed firms to meet peer group results and financial benchmarks. Time was spent on endless peer groups and proxy waste mandated by SEC. Disengaged consultants and attorneys were not helpful.
  - Compensation determinations need to include judgment and broad gauge of contributions and business-building
  - Having “independent” consultants who don’t understand the business advise Compensation Committees is glaringly stupid
  - Unfortunately, villains such as the SEC, ISS, and Cuomo will likely have more sway going forward

Confusing Survey & Proxy Data

- With changing landscape, knowing 2007 pay less helpful
  - Firm positioning and circumstances differ
  - Acquiring firms guarantee high percentage of 2007 to retain professionals

- Firms behind in year-end process
  - Distractions and resource constraints

- This year really need to understand data/circumstances
  - Where should compensation be by business unit and aggregate (i.e., 75^{th}, 50^{th}, and 25^{th} could all be right answer)
  - Example: Wachovia has accrued significantly more compensation thru 3Q 2008. Great results? Bonus/retention for Wells Fargo merger?

2009 Fearless Predictions – Tough Times Continue

- 2009 difficult business and compensation environment
  - No momentum entering year
  - Credit woes for autos, credit cards, and commercial real estate
  - Trading environment constrained by capital and risk aversion
  - Asset management down due to 2008 AUM declines
  - Prime brokerage down significantly as hedge fund assets and leverage decline
  - Private equity losses from 2005-2007 vintages begin in earnest
  - Retail and commercial banking under stress

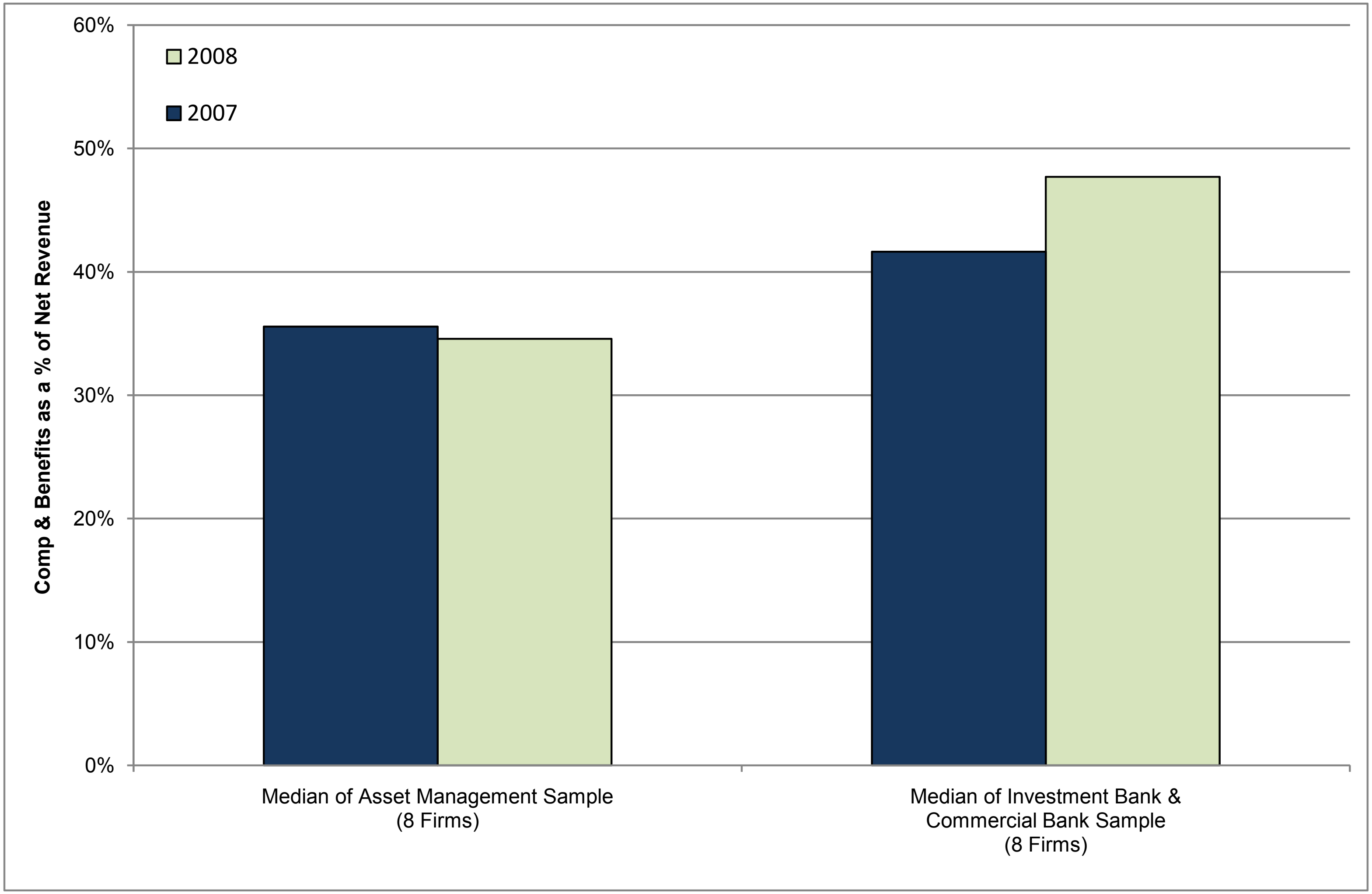
- Government bailout will prove <u>inadequate</u> until federal government increases totals and/or changes terms to more direct investment
  - Most major domestic and global banks are insolvent now
  - Civil/criminal cases mount, moving to full scapegoat mode

- **On broad basis 2009 incentives down 15%-20% versus 2008 as “prop up” effect diminishes**

2008 v. 2007 Compensation as % of Net Revenues

Notes:

- Reflects available year-to-date data
- Select ratios may be skewed high because of the incremental expense for retirement acceleration & SFAS 123R adoption



2008 v. 2007 Compensation as % of Pre-Tax Pre-Comp Income

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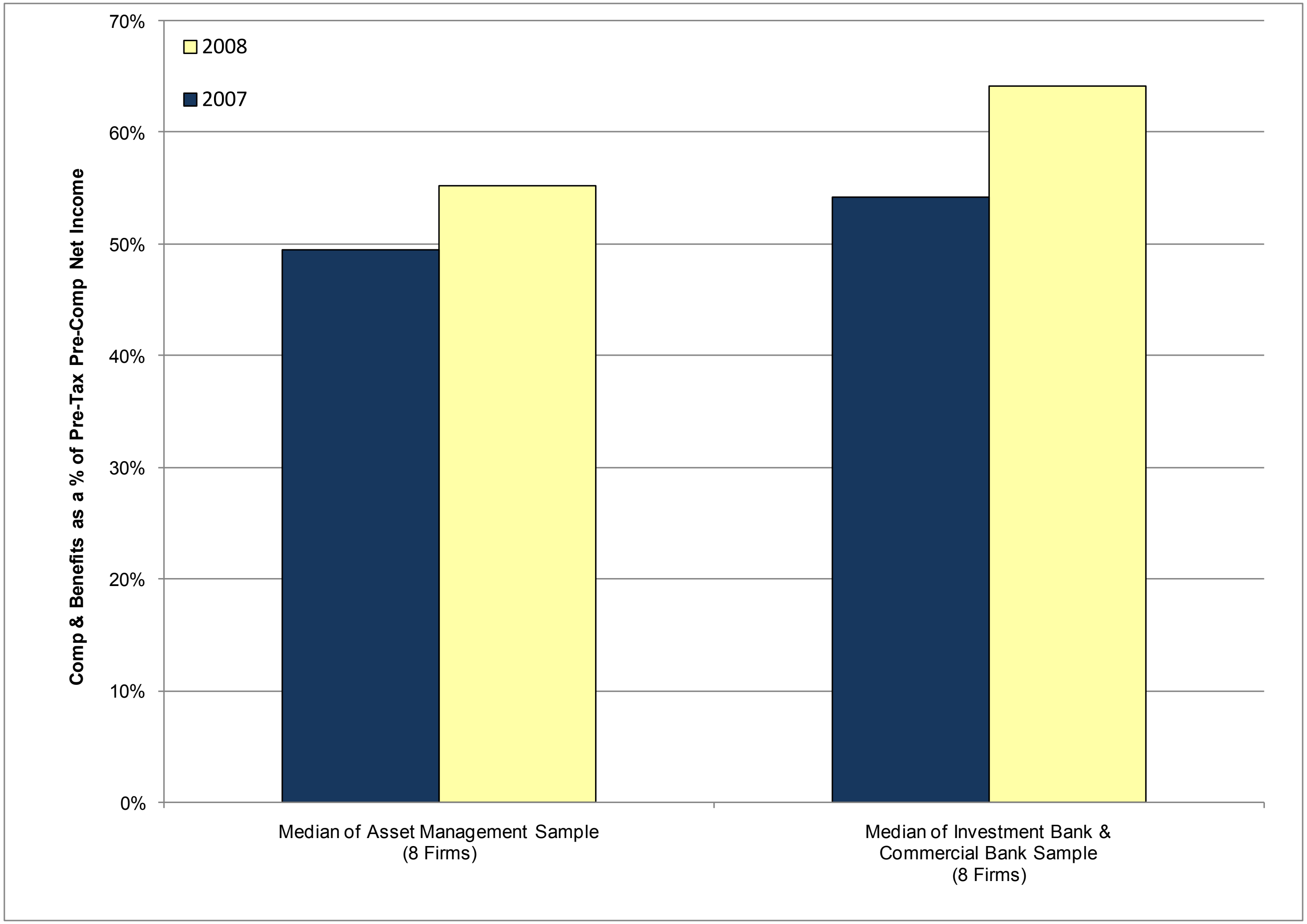
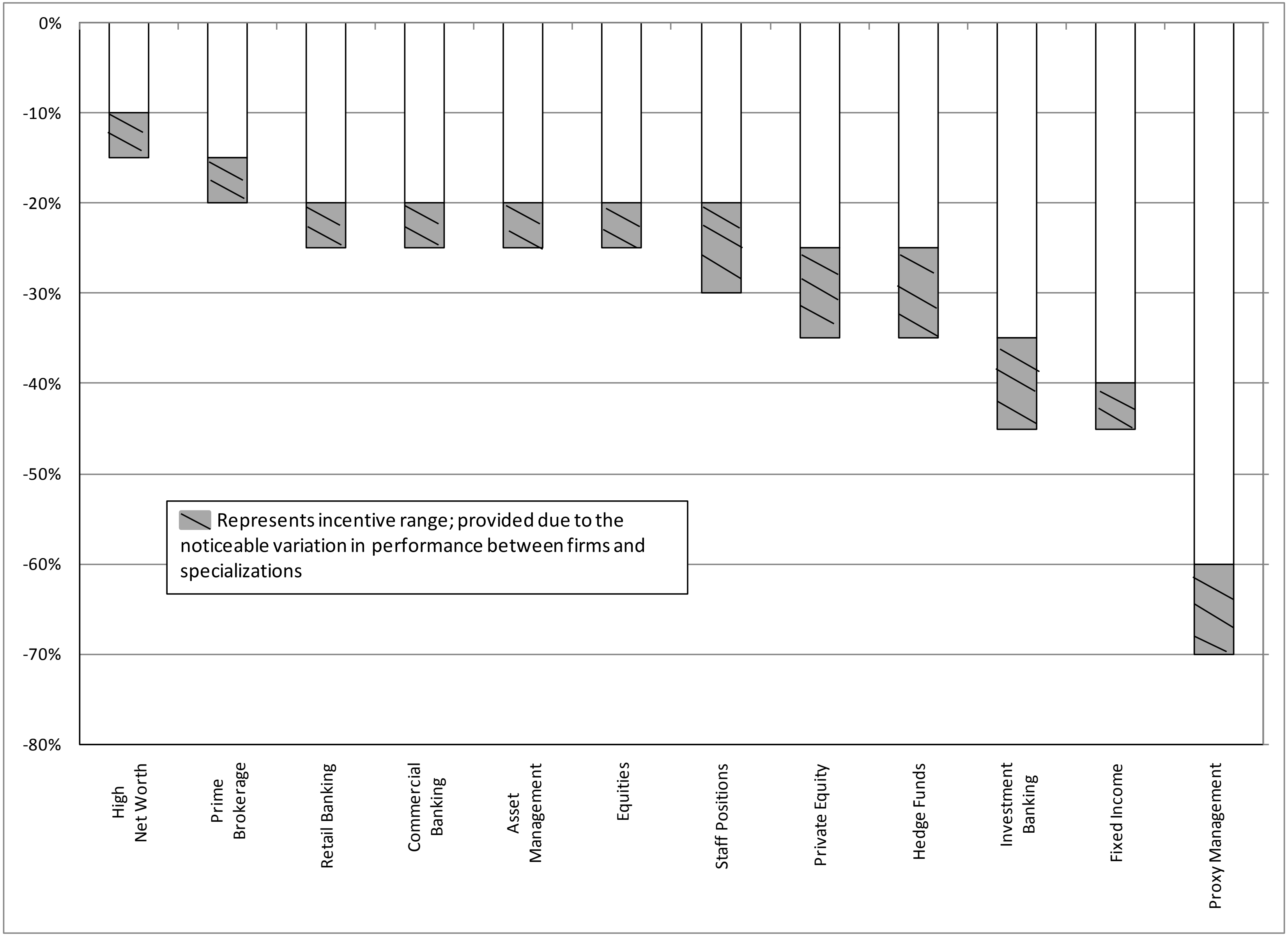


2008 Typical Incentive Changes (Value of Cash Bonus & Equity)



Base Salary Levels

- Industry base salary levels continue at low level
  - ≅ 3.5% increases reflect downturn

- Low nominal base salaries do not mean reduced fixed compensation
  - Often other elements increased or expectations established (i.e., “salary portion of bonus”)
  - Starting to be mentioned more at Board level as odd practice

- 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

- Badly shaken confidence in firm equity as attractive holding
  - Equity will be restricted stock
  - Stock options fall further out of favor due to high Black Scholes (volatility)
  - Movement to providing choices of deferrals into private equity or alternatives

- For large diversified firms, effective single stock difficult
  - Deferrals into funds by asset management participants
  - Fund ownership by alternative professionals
  - Growth of subsidiary plans

- More sensible and specific termination provisions
  - Leaving industry receiving more favorable treatment

Executive Compensation - Tale of Two Worlds

Broad Dictates*

- Limits on deductible compensation
- “No golden parachutes”
- Clawbacks for compensation
- No incentives for excessive risk taking

Government Involvement Proxy Executives	Other Financial Proxy Executives Senior Executives Across Financial Services
• Extreme pressure to reduce cash compensation • Pressure to reduce total compensation • Political calculus highly important	• Market compensation down considerably, but without excess drama

* Details to be hopefully developed but unclear about enforcement and will vary by country

Sales Compensation – Increasing Importance

- Evolving emphasis on sales compensation across businesses
  - Brutally hard in attracting assets in competitive market
  - Recognize sales cycles longer and require multi-year commitments
  - Murky sales process and dynamics in these chaotic markets
- Little modeling of sales timing and predictors
  - Factors impacting timing and magnitudes
  - Real impact of sales professional vis-à-vis products/Firm
- "Stars" attracting expensive offers
  - In difficult times more interest in proven producers
- Objective compensation continues to dominate
  - Exception is alternatives where institutional sales often discretionary and problems with formula-based compensation

Investment Banking

- 2008 compensation for senior professionals much lower
  - 2009 incentive compensation will decline again (i.e., 15%)
  - Subsidy from trading gone – must be viable on own revenues

- Weak pipeline entering 2009 on built-out teams and resources
  - Capacity will exceed volumes even as layoffs continue

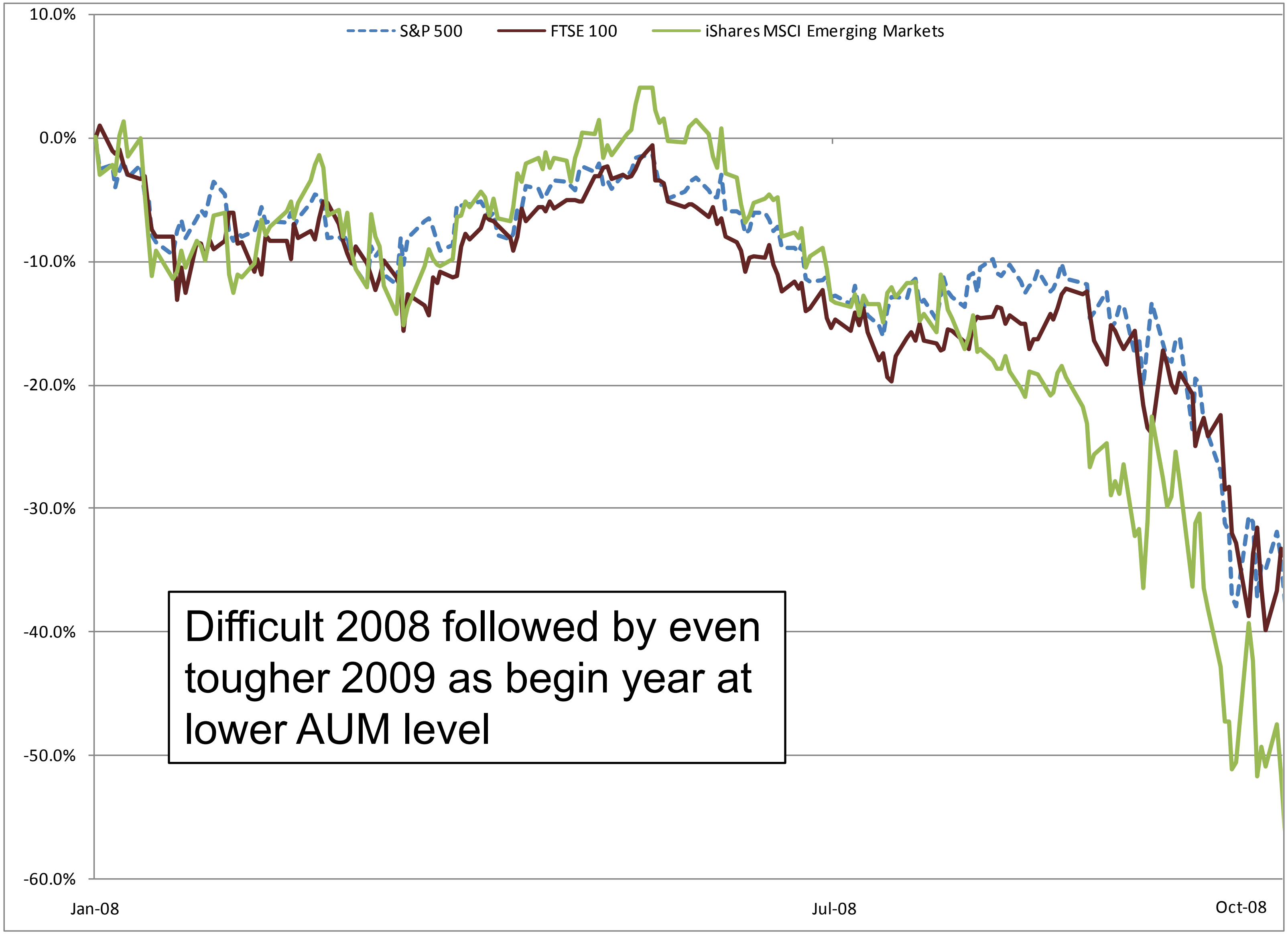
- Equilibrium in research
  - Two-tiered market of few visible seniors and number of lower-level. Increasingly few mid-level professionals
  - Buy-side research pays better with enhanced careers
  - Hedge funds influence weakens

- Staff reductions reflecting excess capacity
  - Pattern of U.S. layoffs with selective hiring internationally

Asset Management

- Trying to jam asset management into Wall Street/Insurance pay and business norms creates underperformance
  - Long-tailed business with heavy mix of structured pay
- Partner pay model common
  - Pre-agreed % of operating profit available for incentives
- Sales
  - "Commission" plans with 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
- More subsidiary equity programs are required
  - Investor and consultant requirements
  - Lure of independent firms

Asset Management



Private Equity – Whistling by the Graveyard

- Major structural problems in industry
  - Questionable transactions completed and huge funds raised

- 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
  - Fund sizes provide ample compensation resources

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

> • 2005-2007 investment vintages will suffer major losses and sweep in brand name funds. Spillover effect to fund-of-fund investors

Hedge Funds – Bubble Bursts

- Hedge Fund returns may be down ≅ 20% by year-end
  - Exposes real value proposition and importance of leverage
  - Oversold to high net worth clients
  - Reduced leverage provided by prime brokers
  - Difficult to produce adequate risk adjusted returns

- Expectation of firms closing and fleeing investors
  - Some believe 50% of firms will disappear . . .
  - Will find out if asset class <u>or</u> simply a fee schedule looking for investors
  - Perverse impact of “high-water mark”

- Important to pay adequate 2008 compensation and have viable 2009 pay model
  - Many firms have to reconsider historical pay practices
  - May require firm principals to operate firms at loss in 2008-2009
  - Will need to be creative with “high-water mark” problems

- 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

Summary and Final Thoughts

- Many major financial firms insolvent
  - Harsh and unpleasant reality
  - Wild card variable to all compensation discussions
  - Likelihood of continuing government investments

- Compensation down significantly in 2008
  - Would be down more except for “prop ups” by mergers and bailouts

- Heavy 2008 deferrals akin to 2007
  - Restricted stock and alternative investments

- Beginning Board concerns about basic compensation models
  - “Couldn’t we have a more structured approach – pay targets by individual?”
  - Governments will have same concerns

- Executive compensation under unprecedented scrutiny
  - New unclear laws and regulations
  - Political pressures extreme
  - Proxy/non-proxy different perspectives