2011 Compensation and Lessons for 2012 and Beyond

Wall Street Compensation and Benefits Association

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19 West 44th Street, Suite 511, New York, New York 10036
(212) 221-7400 • Fax (212) 221-3191

Introduction

Johnson Associates

- Independent financial services compensation consulting firm. Pure advice, annual and long-term incentive designs, market data and levels/ratios, agreements, and goals/metrics. Equity and partnership considerations. Expertise and in-depth knowledge across comparators, labor markets, and regulatory/political considerations
  - Experienced, opinionated and informed
  - Both Board consultant and company programs

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

2011 Compensation Recap

- For 2011, significant unexpected broad decline in incentive funding by sector and area
  - Major Investment and Commercial Banks (i.e., -20% to -40%+) driven by Fixed-income and Equities (i.e., -30% to -50%+), Commercial Banking (i.e., -5%), Investment Banking (i.e., -20 to -30%+), and Wealth/Asset Management (i.e., +5%)
  - Market-based businesses mixed. Asset/Wealth Management (i.e., +5%), Hedge Funds (i.e., -10%) and Private Equity (i.e.,-5%)
  - Investment Banking scaled for bigger volumes
  - Potential disasters (i.e., Greece, Italy, Spain) continue to impact landscape
- Difficult trading environment
  - Narrower spreads, yield curves and rate levels, and reduced capital usage
- Challenging to manage expectations, decipher market trends and recognize performance
  - Impact of regulation and public sentiment
- Moderate retention concerns in early-to-mid 2012
  - Labor market continues to weaken
- Very heavy Wall Street deferrals continue for 2011, variations by region
  - Accruals from heavy 2009/2010 deferrals meaningfully reduced 2011 earnings. Creates additional volatility in earnings along with own debt valuation

2011 Compensation Recap

- Base salary levels reach equilibrium
  - Little appetite for broader increases

- "Say on Pay"/ISS damage relatively moderate
  - Greater damage elsewhere in economy

- Renewed interest/obsession with compensation ratios
  - Firm level - absolute and versus peers
  - Business unit comparisons
  - Short vs. medium-term considerations

- Differences between Wall Street vs. Financial Services
  - Impact of regulation and perceptions/expectations
  - Deferrals and flexibility

- Overarching frustrations/questions remain unsolved:
  - "Why does overall firm not decline fully with results?"

  - "For material risk taker, explain clear link between performance and compensation. However, avoid formulas, maintain significant discretion, include business and firm performance, and appropriately reflect social/political environment…"

“Why Does Overall Firm Compensation Not Decline Fully With Results?”

Easy Part of the Answer

- Base salary is fixed
- Benefits are fixed
- Most other expenses +/- fixed
- Deferral expensing obscures current compensation

Hard Part of the Answer

- Most high-earning professionals are, more or less, individual contributors
- Labor markets exist and reasonably transparent
- Few high-earning professionals have accountability/line-of-sight to firm performance
- Businesses do not move in sync (nor should they)

Industry NOT Alone

- Executive search, public relations, and consulting firms have similar constraints, their compensation does NOT move directly with results

∴ ***Expectation that overall compensation will vary directly with firm results is NOT realistic, and does NOT occur across other heavily human capital intensive industries***

Explain Material Risk Taker Compensation

Regulator Agendas

- Not encouraging excessive risk taking
- Consider risk at individual level
- Aversion to high-compensation determined by discretion
- Political opportunity; little downside in micro-managing compensation
- High fixed costs with ample staffing

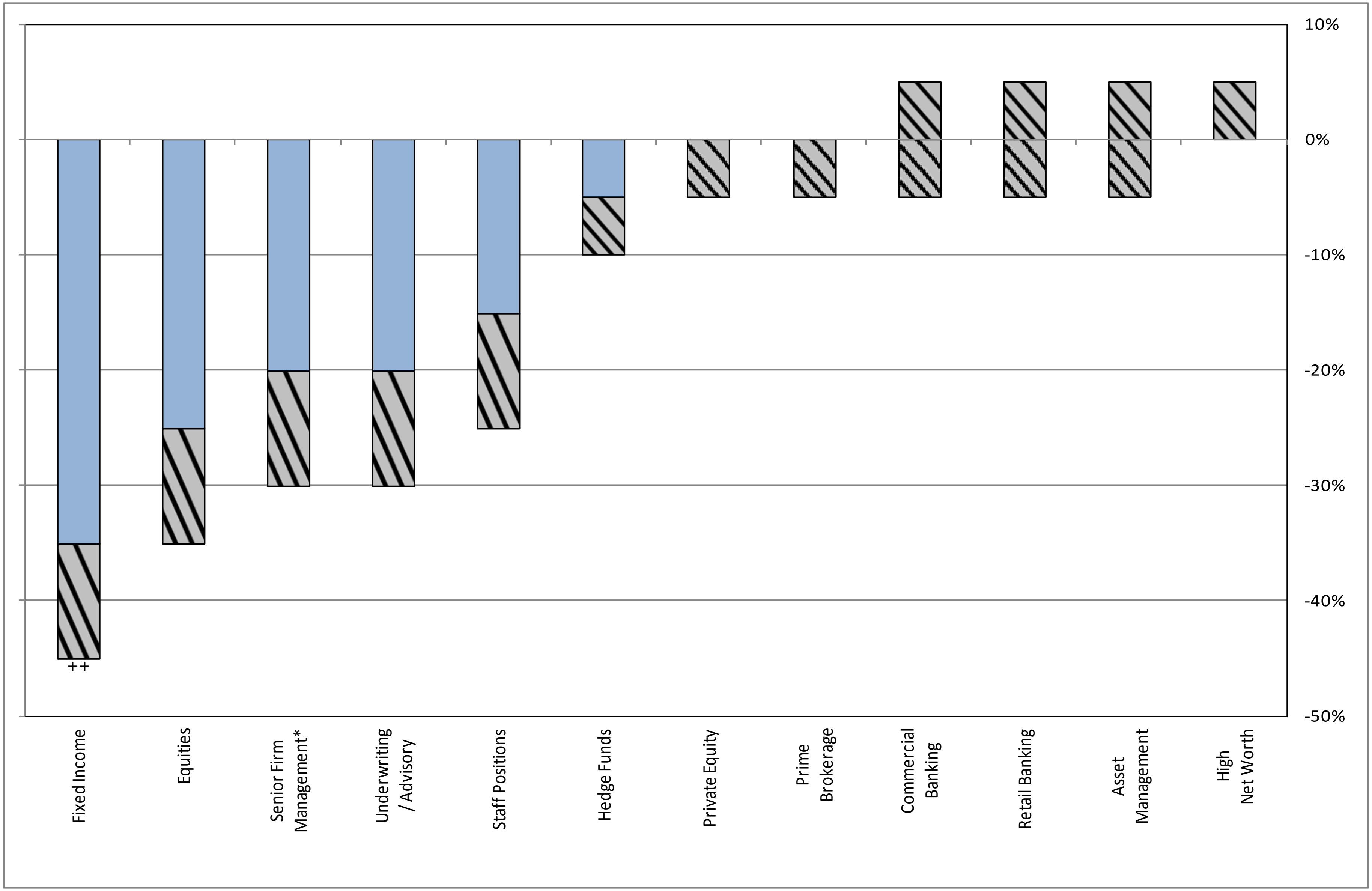
Continued Friction on Material Risk Taker Compensation

Firm Agendas

- Returns to shareholders
- Take sensible risks across diversified businesses
- Avoid formulas and silo behaviors
- Recognize high-compensation can come from discretion
- Market competitive and performance based

∴ ***Likely an ongoing issue, with compensation plan risk reviews, risk based funding, and established/exception reviews acting as counterbalance***

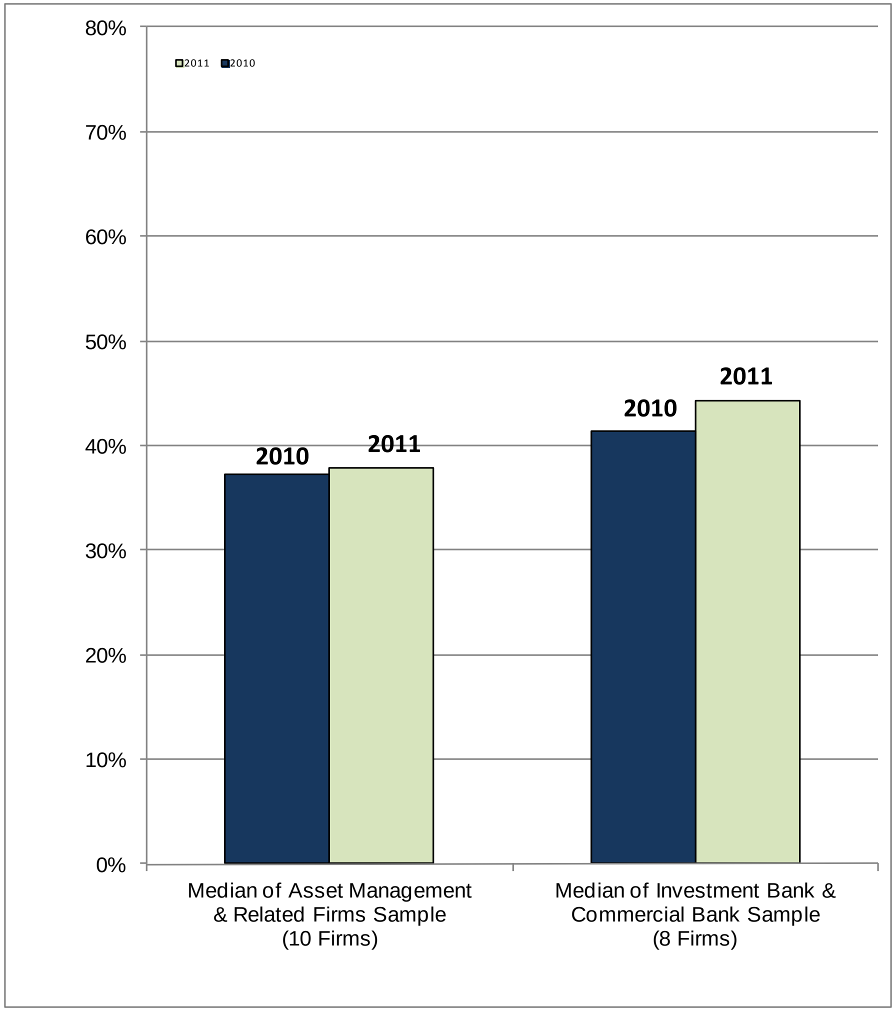
2011 Typical Incentive Changes (Value of Cash & Equity)*



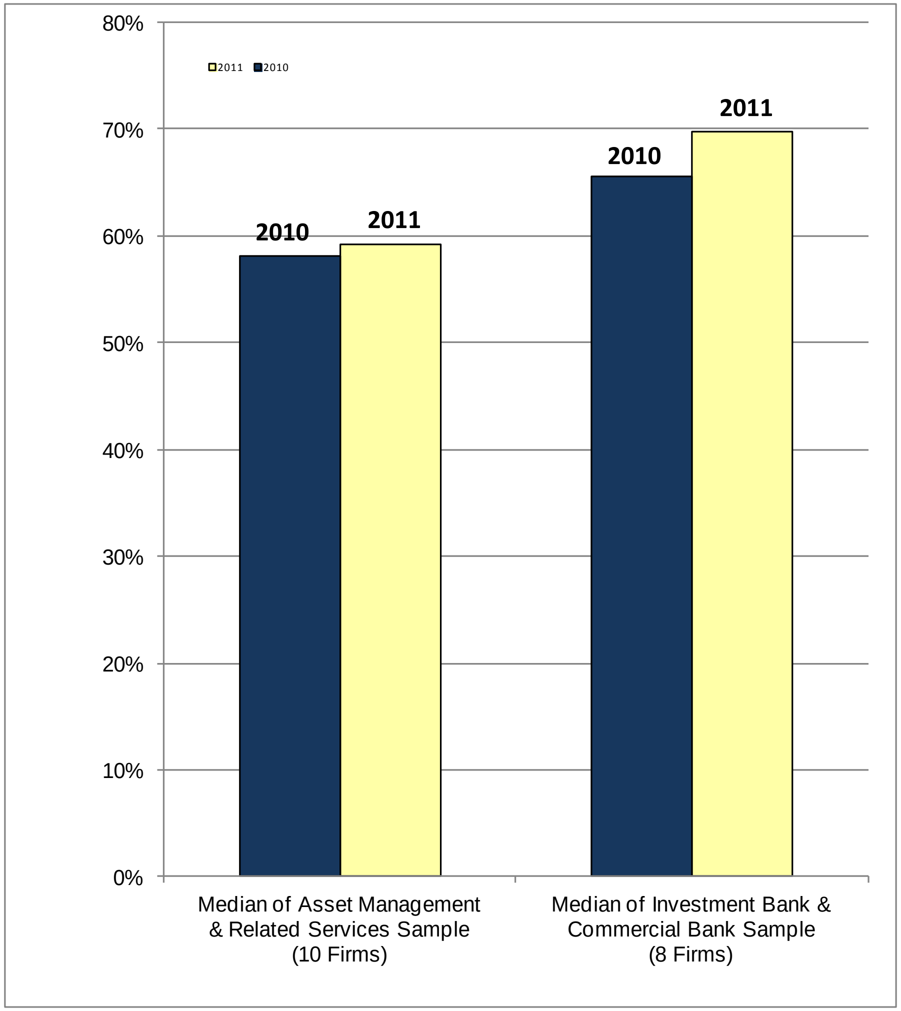
* “same store” basis

2011 vs. 2010 Compensation Ratios

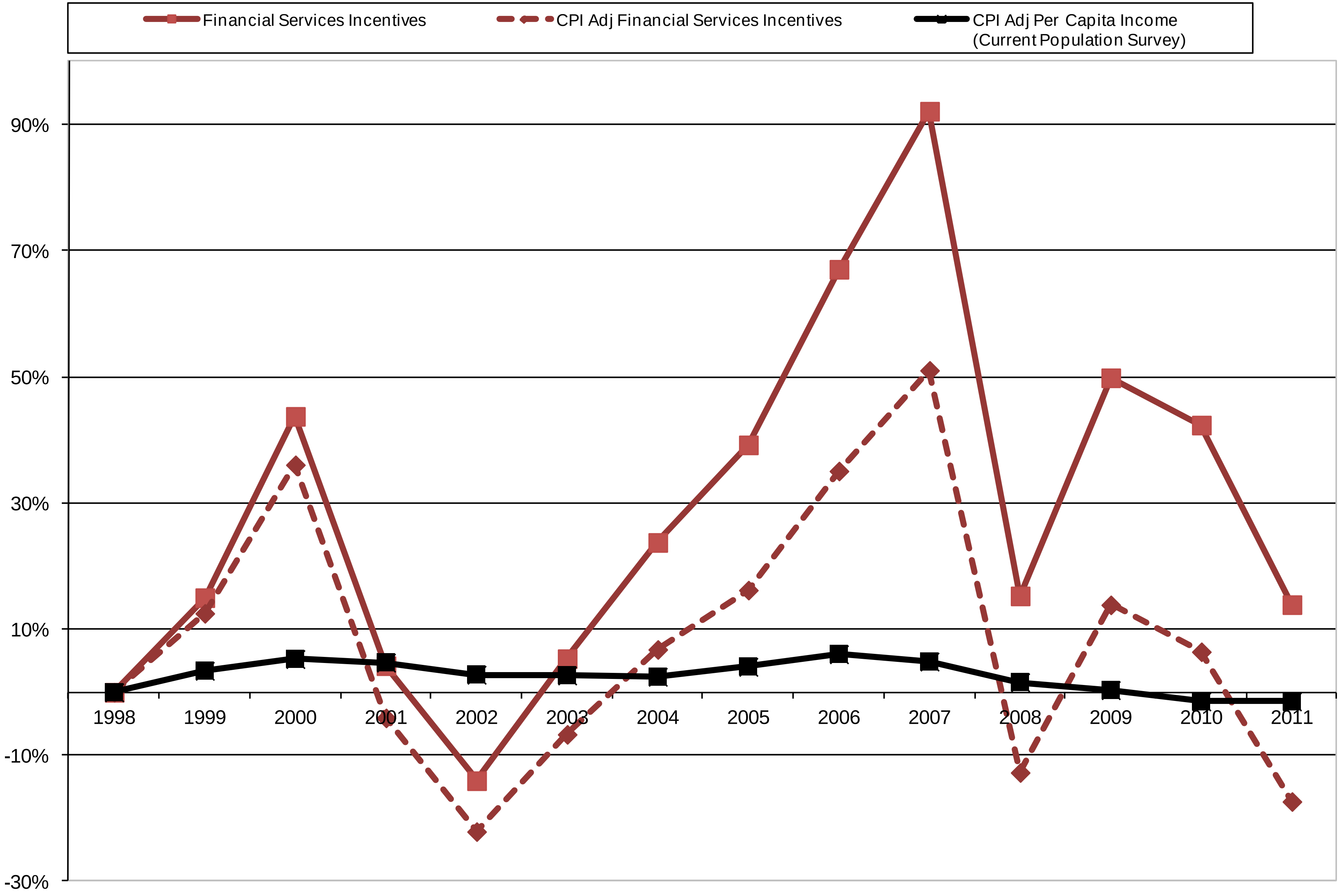
Comp & Benefits as % of
Net Revenue



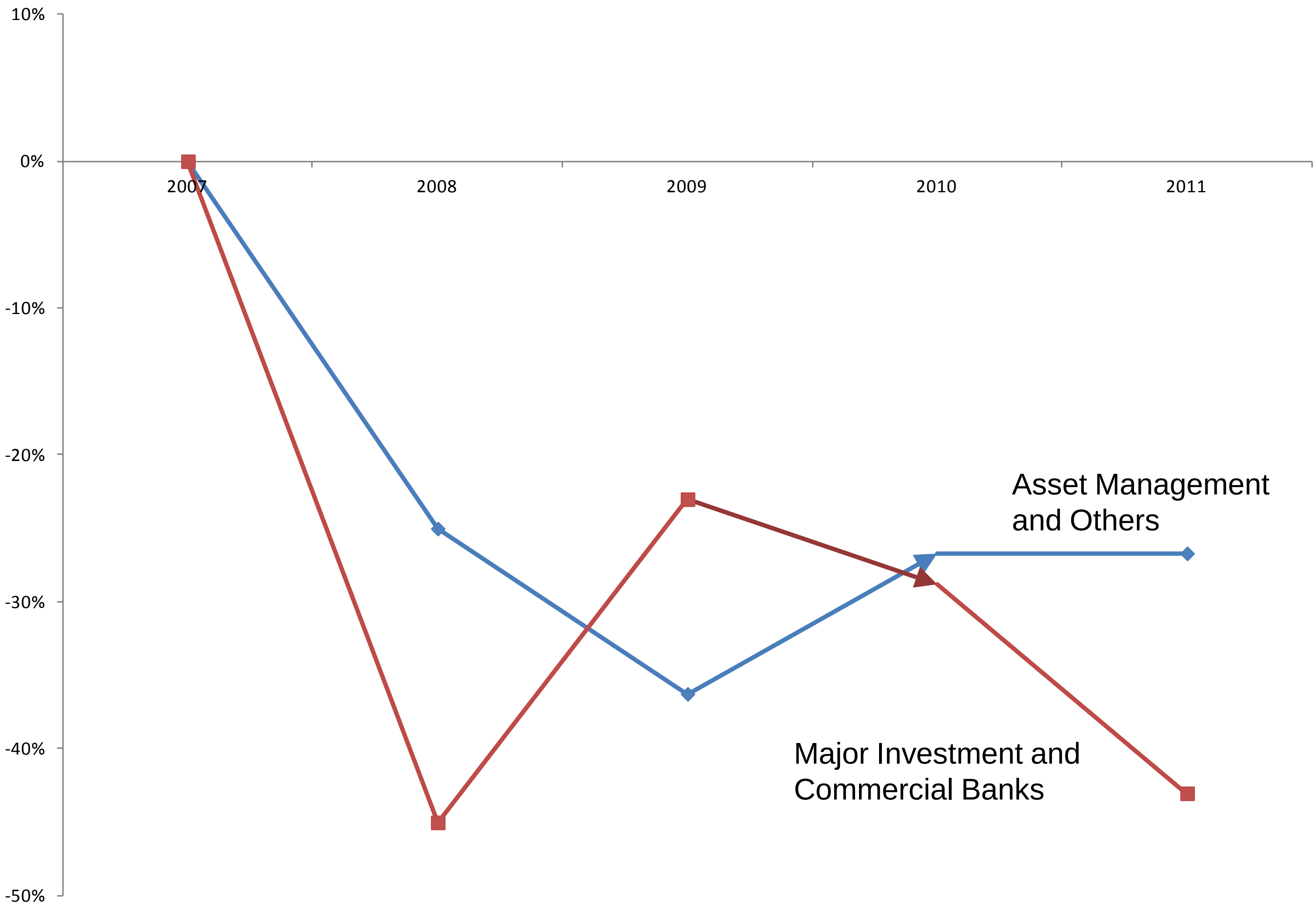
Comp & Benefits as % of
Pre-Tax Pre-Comp Net Income



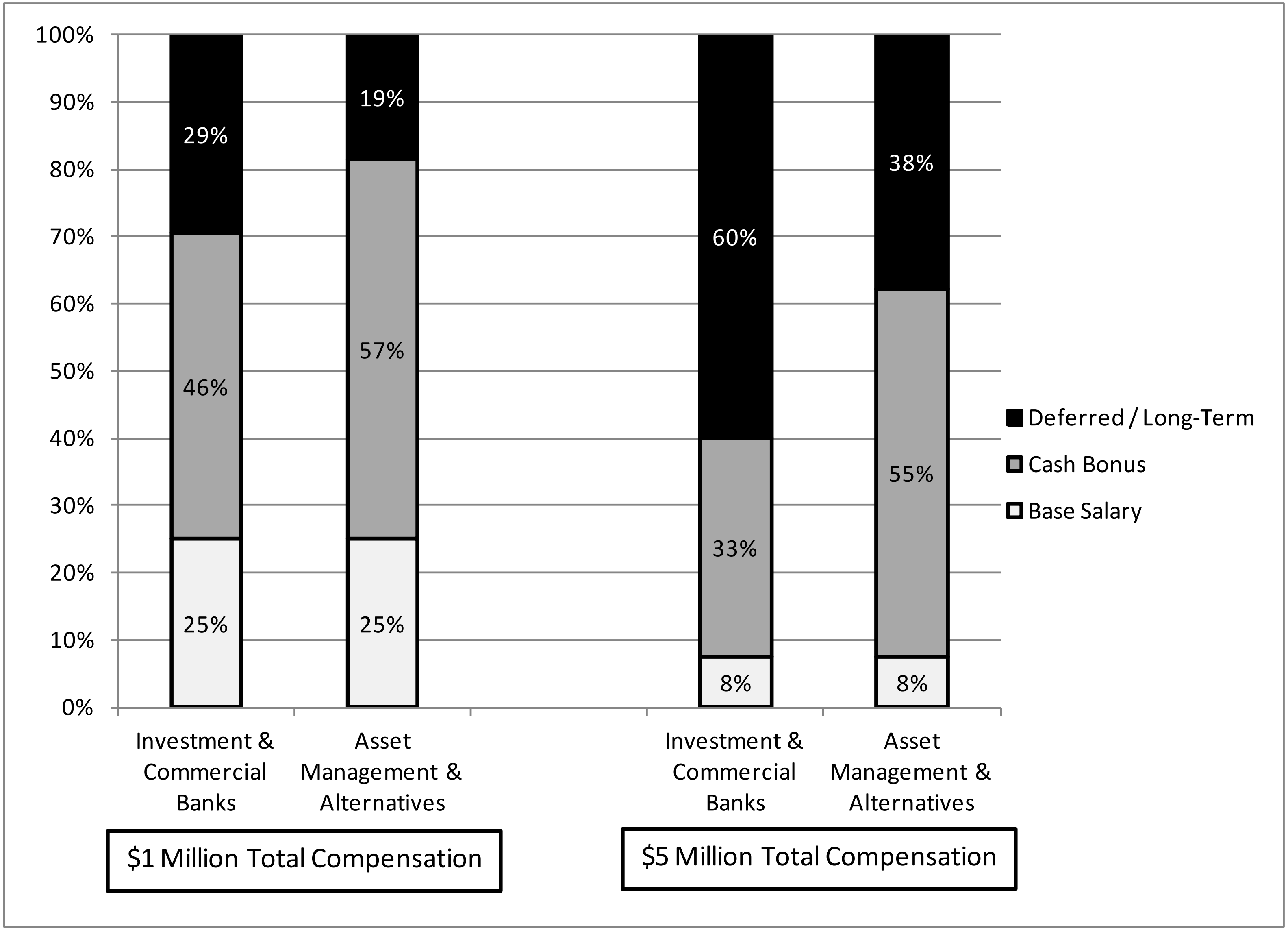
Incentive Changes from 1998 – 2011



Incentive Trends Fairly Reflects Markets



Pay Mix: Difference Between Sectors



Compensation Regulatory Key Updates

- A significant by-product of regulation is the implementation of cash compensation "caps"

Federal Reserve	Risk • Including a charge for liquidity risk for internal profit measures across incentive awards favorably viewed Risk Assessment • Quantitative risk measures preferred, however recognizes very difficult to implement. Judgment-based decisions more prevalent Deferral Latitude • Does not : (i) require deferral for all employees, (ii) suggest any specific formula, (iii) mandate any specific vehicle More Performance-Based Deferrals • Prefers performance-based deferral coverage to more employees Interaction between Committees • Increase communication between the compensation committee and risk/audit committees
Dodd-Frank	• Broadly defines and bans proprietary trading by banks with FDIC, limiting investments in 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
FSA	• Compensation Committee Chairman required to certify firm compliant with the rules on compensation structure

2012 Fearless Predictions

- 2012 incentives increase significantly from 2011 bottom (i.e., +20%)
  - Fixed income and equities up from very poor 2011
  - Investment banking improves with economy
  - Commercial and retail banking better
  - Asset and wealth management benefit from stock market improvements
  - Impact of significant and ongoing cost cutting/focus

- Ongoing regulatory/political issues
- Crisis continues across Europe but full-blown disaster averted
- Proxy compensation continues to increase, but unevenly
- Positive for hedge funds and private equity-fund raising and returns
- More difficult for firms owned or controlled by governments
- Continued difficulty in communicating basic compensation model

∴ ***Industry has reached inflection point. During 2012 – 2014 compensation and results should improve as industry moves closer to long-term expected ROE (i.e. ≅15%)***

Executive Compensation

- 2012 continues movement to longer-term market levels
  - Executive view: market compensation for market performance
  - ≅15% ROE produces lower pay than 25% ROE during boom
  - CEO normal for large banks ≅$13-$23 million. 2012 should be mainly in that range

- Need to manage external expectations continues
  - Greater transparency of link between compensation and performance needed. Continuing uncertainty not helpful
  - Formulas with discretion would be improvement

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

Potential Deferral Vehicles

- With high deferral rates need alternatives to firm equity
  - Recognize regulatory constraints

- 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

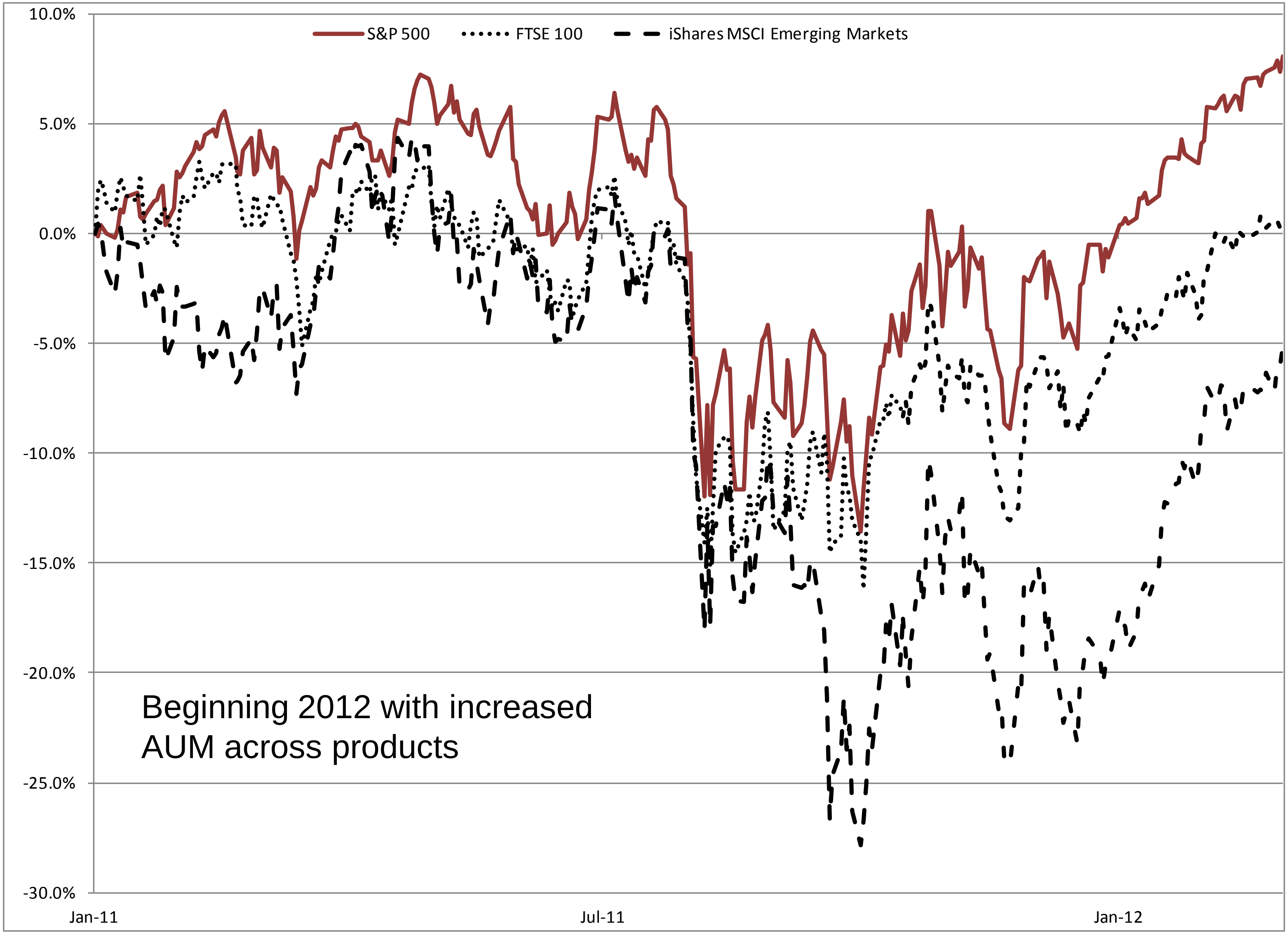
Asset and Wealth Management

- Increase in 2012 revenues drives major incentive increase
  - Up 15% from 2011 (which was up 5% from 2010)

- 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 (and now coming)
  - Investor and consultant requirements
  - Lure of independent firms

Impact of Market on AUM Businesses



Hedge Funds – Recovery Continues

- Hedge Funds had uneven 2011 returns
  - 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

- Struggling with ownership transitions/partnership
  - Need to establish reasonable comprehensive terms
  - Difficult due partially to DNA of founders

Private Equity – Improvement and Growth

- Industry in rebound
  - 2008-2011 investments promising
  - Benefitting 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.)
  - Professional carry at institutional firms 10-13 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
  - Investors continue to look to alternatives for needed returns

- Global opportunities become key part of the mix

- **Continued improvement in fundamentals plus luck (Dodd-Frank/Volcker), much better prospects than 12-24 months ago. However, often disconnect on carry opportunity depending on which funds participating in**

Board of Director Role and Pay Implications

- Increased time commitments, complexity of issues and new legislation/ regulation more evident than ever
  - Pressure for increased accountability
  - Imprecise and lengthy
  - Unprecedented scrutiny of pay designs and magnitudes

- Transparency and proactive communication between Boards and management
  - Crucial importance of open communication
  - Boards retain discretion on payouts
  - Quarterly assessment increasingly needed. Broader scorecard helpful

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

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

Summary and Positive Thoughts

- 2012 compensation will be up meaningfully for most firms
  - Trading up off of poor 2011
  - Investment banking improves moderately
  - Commercial and retail banking up with economy
  - Asset and wealth management/brokerage up significantly

- New reality taking hold (but not without effort)
  - Better signals of executive compensation
  - Improved communication with directors/regulators on needed spend
  - Deferral choices
  - Compensation ratio analysis drives need for greater transparency
  - In context of lower cost bases

- Asset and consumer businesses become increasingly positive and important

∴ ***Believe industry is at positive inflection point. Compensation will increase significantly as firms move closer to ≅15% ROE norm over 2012 - 2014***