2012 Compensation and Improving yet Cloudy 2013

Wall Street Compensation and Benefits Association

March 2013

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Contents

- Independent financial services compensation consulting firm. Informed advice and counsel, 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

2012 Compensation Summary

- Modestly positive 2012 off of poor 2011 incentives
  - Major Investment and Commercial Banks (i.e., -5% to +10%+), driven by Fixed-income and cost cutting. Commercial Banking (i.e., +5%), Wealth/Asset Management (i.e., +5%) Investment Banking (i.e., -10%), and Equities (i.e., -15%)
  - Market-based businesses positive: Asset/Wealth Management (i.e., +5%-10%), Hedge Funds (i.e., +10%) and Private Equity (i.e.,+5%)
  - Significant impact of cost cutting and strategic exits
  - Europe weaker/much weaker. In short-term, different compensation market
- Better Fixed Income
  - Moderately better volumes and streamlined platform
- Poor year for Equities
  - Weak volumes and tight spreads
- Challenging to manage expectations, decipher market trends and recognize performance
  - Impact of regulation and public sentiment
- Moderate retention concerns for 2013
  - Labor market continues weak
  - Recruiting “reluctance” and implications
- Significant variations in deferrals between major banks and other financial services
  - Places banks at disadvantage, and creates opportunities for others

2012 Compensation Summary

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

- “Say on Pay”/ISS damage generally moderate but ongoing
  - Better peer groups
  - Continues to focus on form over substance

- Renewed interest with compensation and funding ratios
  - Firm level - absolute and versus peers
  - Business unit comparisons
  - Short vs. medium-term considerations
  - Misunderstandings on low capital businesses and higher funding rates

- Use of long-term plans makes market analysis more difficult
  - How to factor in awards made years ago

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

- Overarching frustrations/questions remain unsolved:
  - “What is the appropriate balance between employees and shareholders? How can the question be appropriately framed”
  - “Why can’t incentives go to zero?”

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

Easy Parts of the Answer

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

Hard Parts 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)
- Incentives are variable within a range

Industry Not Alone

- Executive search, public relations, and consulting firms have similar constraints, their compensation does <u>not</u> move directly with results

∴ ***Expectation overall compensation will vary directly with firm results is <u>not</u> realistic, and does <u>not</u> occur across other heavily human capital intensive industries***

Regulatory and Political Issues

U.S.	Europe
• Covered employees • Documentation and back-testing • Malus/clawback • "Say on Pay"	• EU compensation caps • Malus/clawback • State-owned/dominated banks (i.e. U.K./France) • Minder (Switzerland); Germany, France, next

- Intersections of anger over CEO compensation and continuing fallout over banks

Compensation Caps and Implications

- EU compensation cap beginning in 2014 may apply to code staff/material risk takers and limits incentives to 2x-2.5x+ base salary
  - EU rules still in flux and likely remain so during 2013

Example of EU Cap at 2.5X

Total Compensation	2.5x Incentive	Base Salary
$ 1 Million	$ 700k	$ 300k
$ 3 Million	$ 2150k	$ 850k
$ 5 Million	$ 3600k	$ 1400k
$ 10 Million	$ 7150k	$ 2850k
$ 15 Million	$ 10,700k	$ 4300k

- Minder initiative in Switzerland, while not imposing explicit caps, results in binding shareholder vote on executive pay

- Variety of solution/issues
  - High salaries and ability to change/reduce
  - Impact on benefits
  - Commissions
  - Pensions/retirement schemes
  - Partial year coverage

Importance of Understood Compensation Funding

- Increasingly important for senior management and Compensation Committee to have clear understanding of market funding for given level of results
  - Performance driving compensation
  - Market position impacts compensation
  - Expected market movements

- Much better for informed discussion with rational starting points/boundaries
  - Rather than perhaps confusing discussions in a near vacuum of year-over-year change
  - Importance increases as business mix changes and historic patterns/expectations become less useful

Recruiting “Reluctance” and Implications

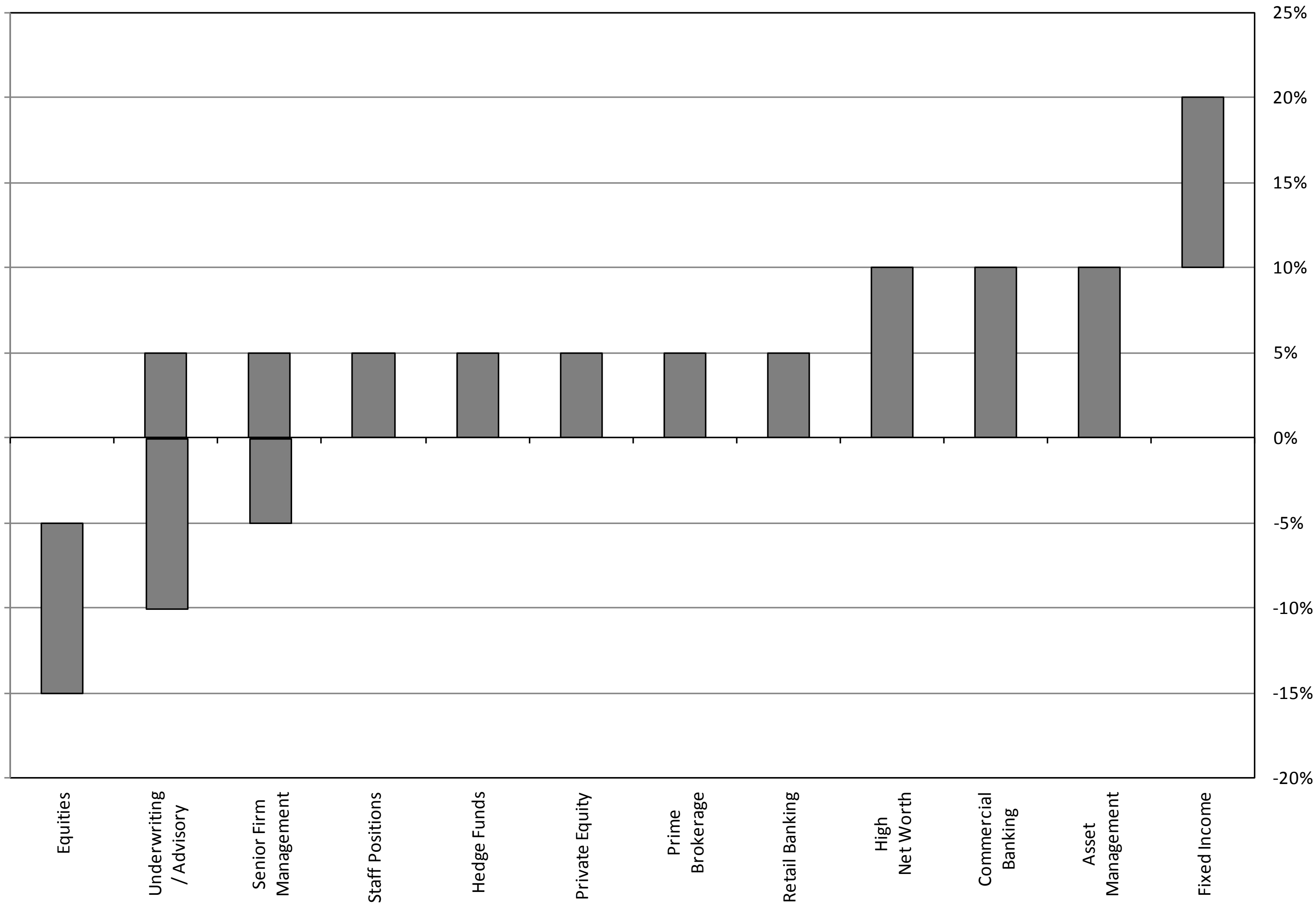
- Historically, voluntary turnover was key indication of compensation, culture, and career shortcomings. In recent years professionals have become increasingly wary of changing firms

  – Real/perceived risk of new firm
  – Greater deferral balances
  – Waiting until industry directions clearer
  – Fatigued after 2008-2012 grind

Reduces risk of professionals leaving. Greater chance of staying and being unproductive and disengaged

∴ ***Firms have improved in managing talent, but need to be more proactive generally, not just with weaker performers***

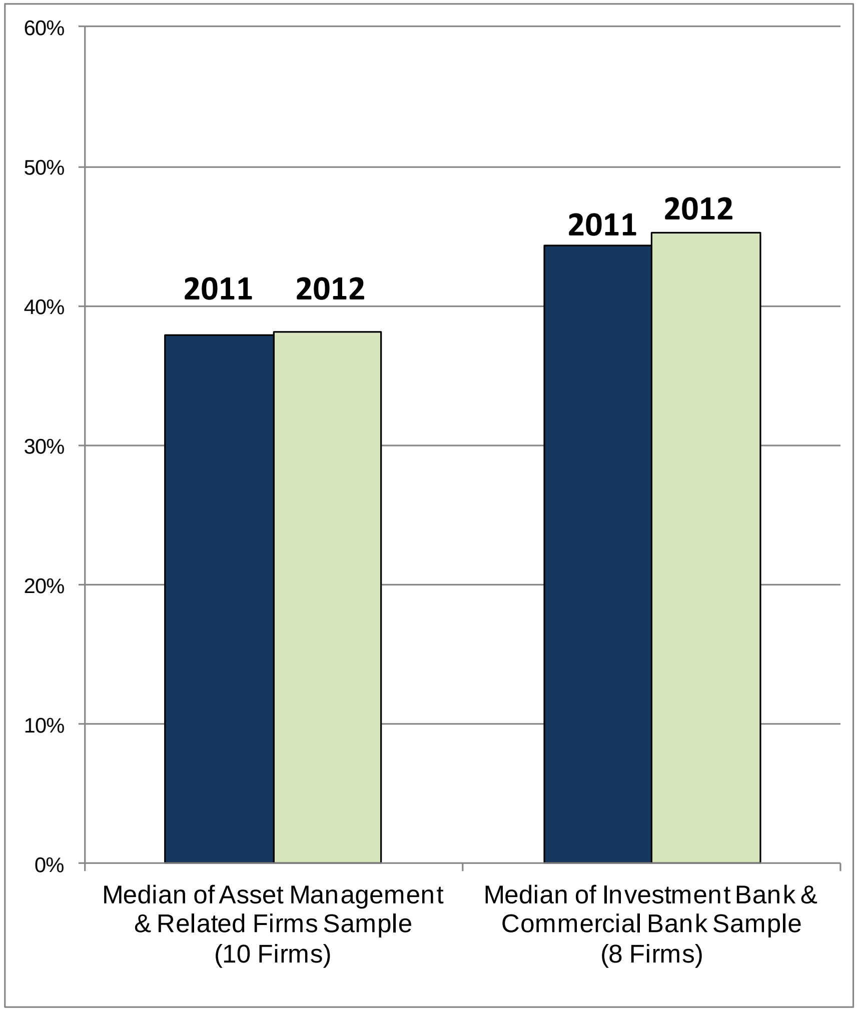
2012 Typical Incentive Changes (Value of Cash & Equity)*



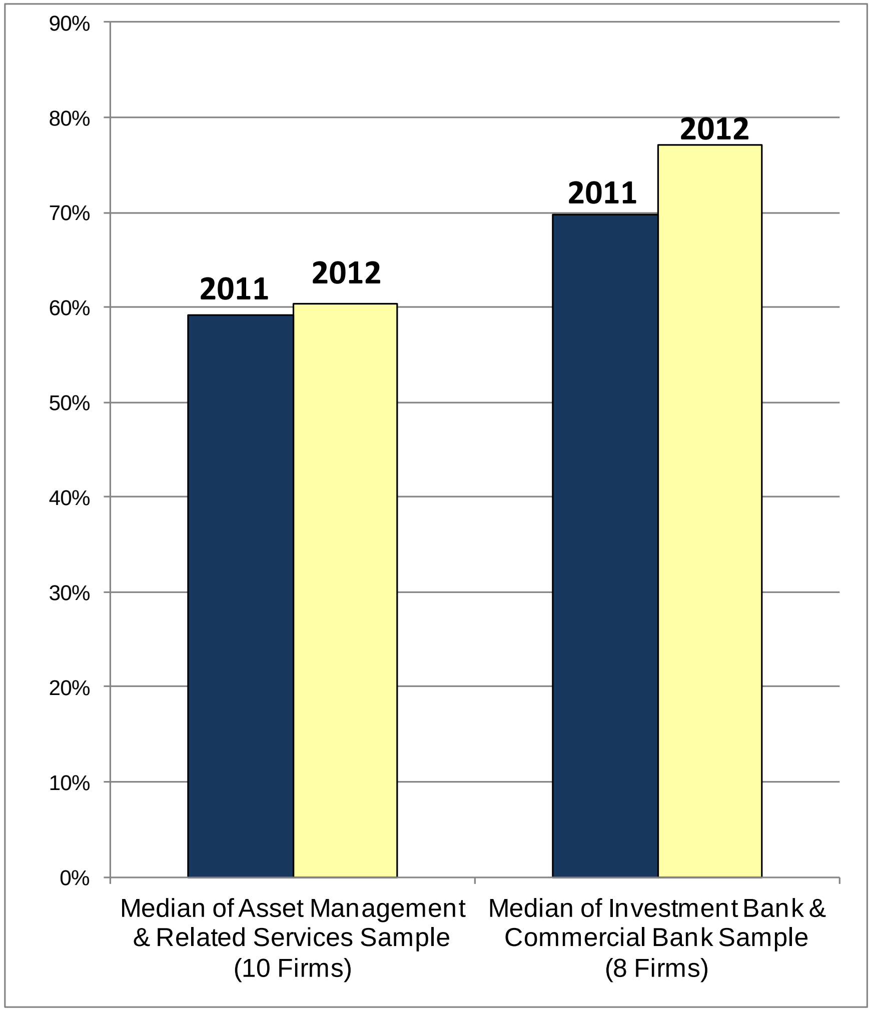
* “same store” basis

2012 vs. 2011 Compensation Ratios

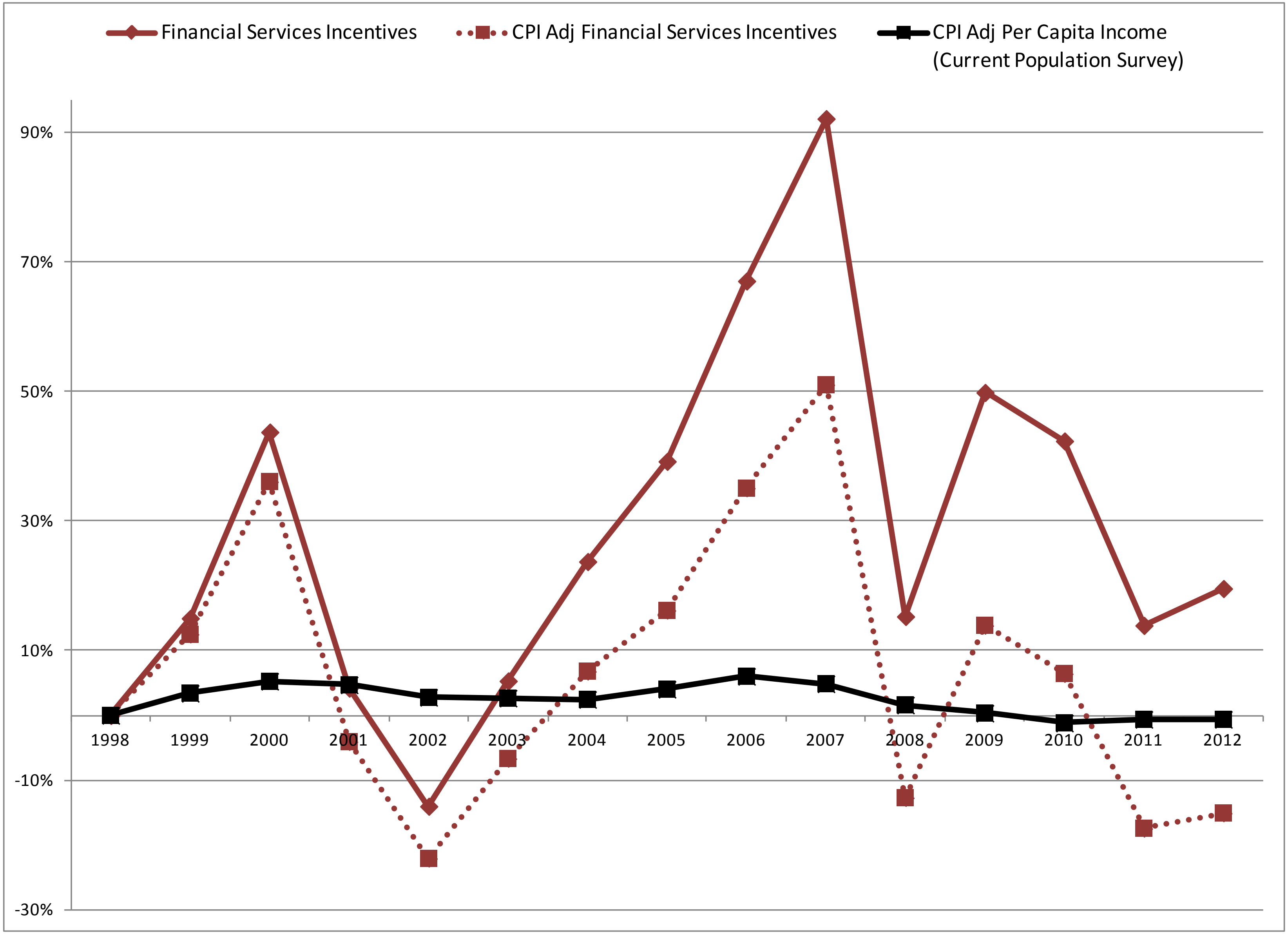
Comp & Benefits as % of Net Revenue



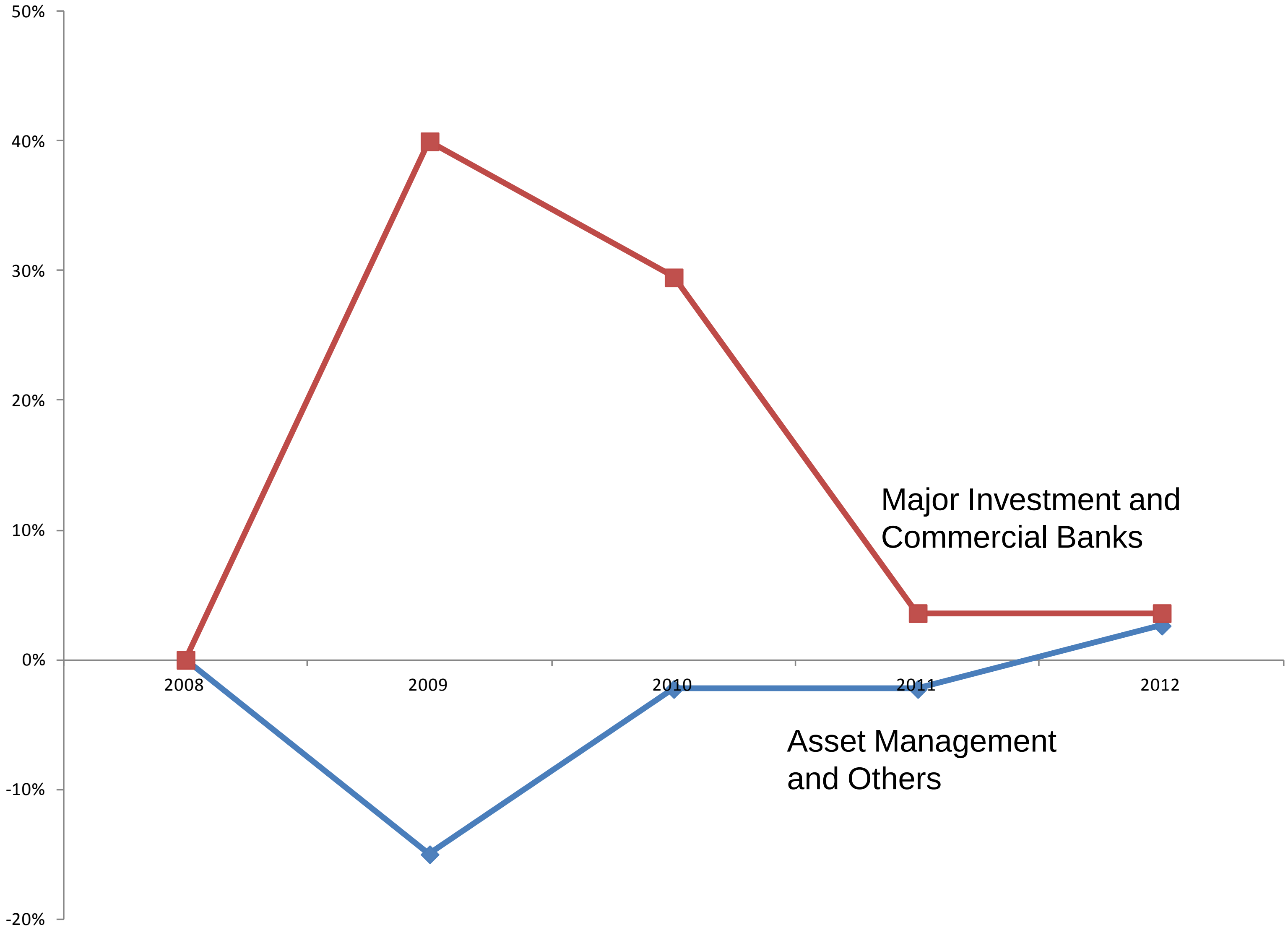
Comp & Benefits as % of Pre-Tax Pre-Comp Net Income



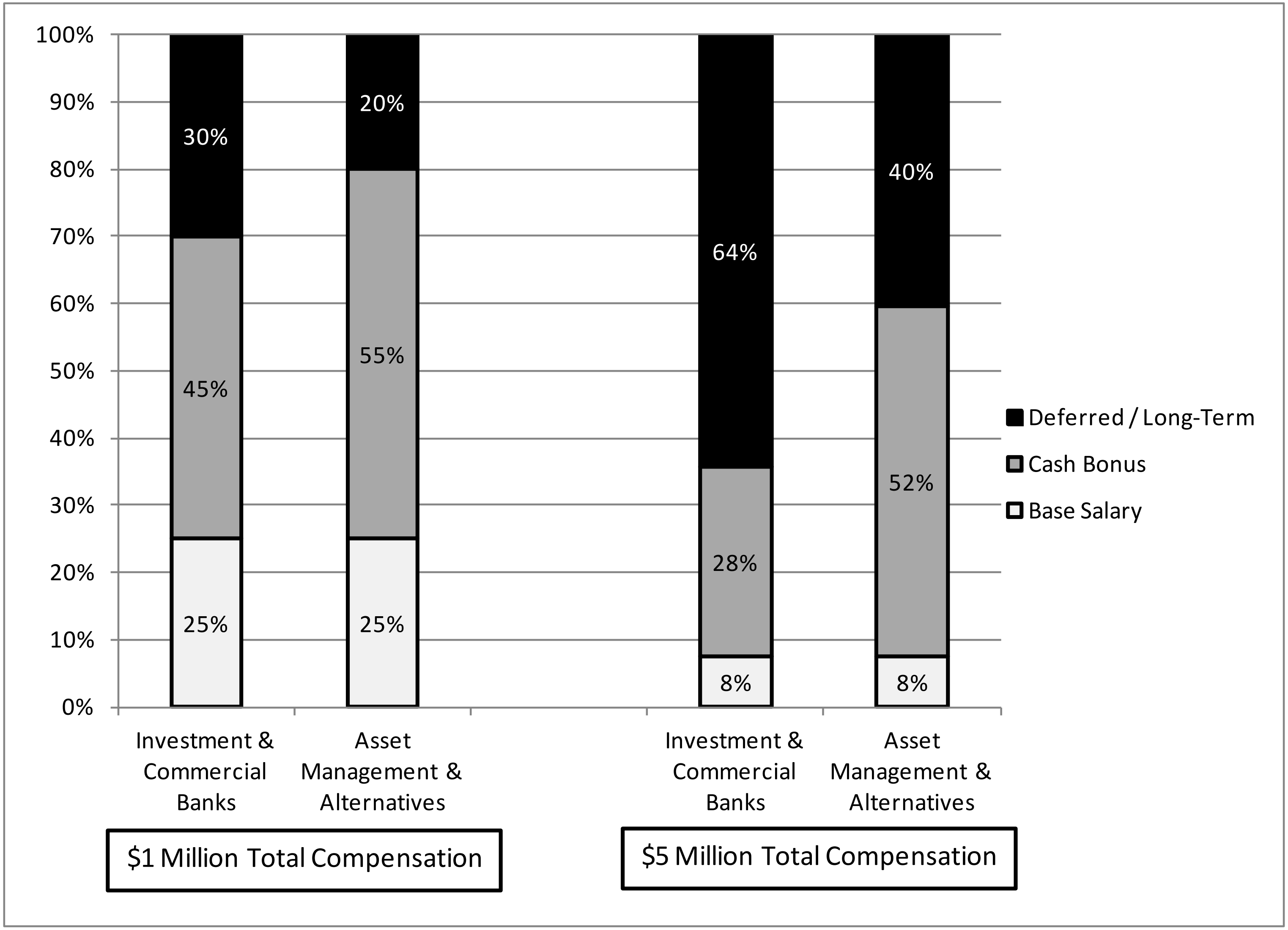
Incentive Changes from 1998 – 2012



Incentive Trends Reflect Volatile Markets



Pay Mix: Difference Between Sectors



2013 Fearless Predictions

- 2013 incentives increase meaningfully from 2012 (i.e., +15%)
  - Fixed income continues to improve. Equities better
  - Investment banking improves with economy
  - Commercial and retail banking benefits from cycle
  - Asset and wealth management improves with stock market
  - Impact of significant and ongoing cost cutting/focus

- Ongoing regulatory/political issues
- Malaise across Europe, but no disaster
- Proxy compensation continues to increase
- Positive for hedge funds and private equity fundraising and returns
- Continued difficulty in communicating basic compensation model

∴ ***Industry has turned. Moderate economic improvements, smarter use of capital, and cost cutting as industry begins to produce acceptable returns***

Executive Compensation

- 2013 continues movement to longer-term market levels
  - Executive view: market compensation for market performance
  - CEO normal for large banks ≅$12-$25 million. 2013 mainly in that range
  - Long-term plans make it more difficult to determine market. Data will be analyzed several ways

- Need to manage external expectations continues
  - Greater transparency on link between compensation and performance needed. Continuing uncertainty not helpful
  - Targets with discretion become more common

- Need significant ownership guidelines
  - Both active and for two years beyond termination
  - Minimize immediate sale of equity after vesting/restrictions

Potential Deferral Vehicles/Structure

- With high deferral rates need alternatives to firm equity
  - Recognize regulatory constraints
  - Increasingly puts industry in disadvantageous position

- Recognize solutions nuanced by employee level/group
  - More equity for executives, different mix for others

- Alternative approach
  - Separate out vesting for retention and clawbacks
  - Build up balance subject to clawback, but not retention risk

- Range of potential choices (all with issues)
  - Firm equity
  - Contingent capital/return units- EU cap opportunity
  - Firm investment (i.e., hedge funds, private equity, real estate)
  - Asset management portfolios
  - Cash/low risk deferrals

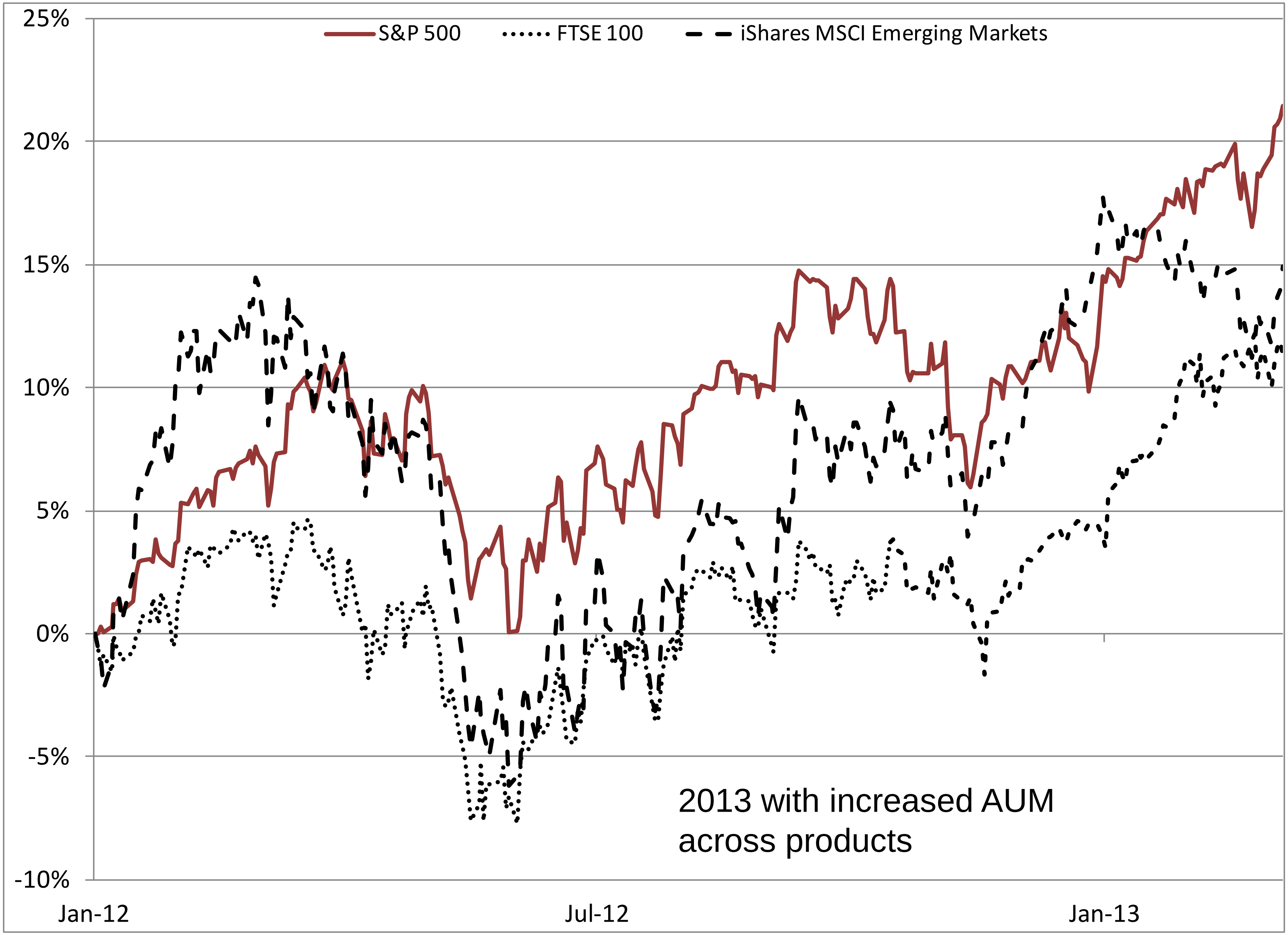
Asset and Wealth Management

- Increase in 2013 revenues drives significant incentive increase
  - Up 15% from 2012 (which was up 5%+ from 2011)

- Business needs different approach (expectation of investors and 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 are happening)
  - Investor and consultant requirements
  - Lure of independent firms

Impact of Market on AUM Businesses



Hedge Funds – Recovery Continues

- Hedge Funds had uneven 2012 returns
  - Most have recovered to “high water mark”
  - Industry assets recovered/fund raising continues
  - More fee pressures coupled with additional expenses; implications on historical arrangements for investment and sales teams

- Potential compensation offering
  - Objective focused compensation
  - Moderate deferrals into funds (but increasing)
  - Addressing cost allocations into units

- Struggling with ownership transitions/partnership
  - Need to establish reasonable comprehensive terms
  - Difficult due partially to DNA of founders
  - Often need multiple equity instruments with varying economics

Private Equity – Improvement and Growth

- Industry in rebound
  - 2008-2012 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 10-12 points (out of 20), reflecting firm economics and fundraising support

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

- Global opportunities become key part of the mix
  - Need to recognize opportunities before markets mature

- **Continued improvement in fundamentals plus luck (Dodd-Frank/Volcker), much better prospects**

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 Optimism

- 2013 compensation will be up meaningfully for most firms
  - Trading up off of disappointing 2012 and poor 2011
  - Investment banking improves off of low base
  - Commercial and retail banking up with economy
  - Asset and wealth management/brokerage up significantly

- Industry reaching equilibrium
  - Better signals of executive compensation
  - Improved communication with directors/regulators on needed spend
  - Deferral choices
  - Compensation funding analysis helps understanding/choices
  - In context of lower cost bases

- Asset and consumer businesses become increasingly positive and important

∴ ***Believe industry has turned. Compensation will increase significantly as firms move closer to market returns***