2007 Compensation and the Gathering 2008 Storm

Wall Street Compensation and Benefits Association

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Introduction

- Discussion of current compensation issues for financial services firms

Johnson Associates

- Independent financial services compensation consulting firm. In-depth expertise across comparator groups and labor markets. Sound practices, annual and long-term incentive designs, market levels and funding, performance goals/measures, and equity/carry distributions

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

2007 Broad Re-Cap

- Moderately reduced compensation versus 2006
  - Strong first 2/3 of year followed by hellish end
  - Well documented disaster in mortgages and structured products
  - Modest decline in other fixed income and investment banking
  - Equities and asset management higher
  - Most firms paid above aggregate levels earned from performance
- Increase in staffing, now unwinding
- Very difficult and erratic year-end process
  - Investment banking subsidized remainder of fixed income
  - Unclear if firms received credit for "paying market"
- Awards almost exclusively restricted stock
  - Extra large deferrals as part of needed compensation
  - Incremental expense pushed into future
- Alarming trend: Hiding pay decisions with late disclosures

2007 Broad Re-Cap

- Massive and continuing breakdowns in risk and governance
  - Hubris and arrogance
  - Little value on experience (i.e., “PhDs in physics taught finance . . . “)
  - Hundreds of billions of losses as yet unrecognized
  - Enron-type accusations and implications
- Competition across high net worth and asset management
  - Asset levels mask structural issues
- 2007 fallout is first real questioning of broad pay paradigm
  - “How can firm lose billions and still pay . . . ?”
- Credit disaster obscured dramatic slowing in late 2007 in core businesses
  - Weak November and December. Poor January 2008 and terrible February
- Cost of living differences clear issue in compensation
  - London costs driving perception/reality of higher compensation

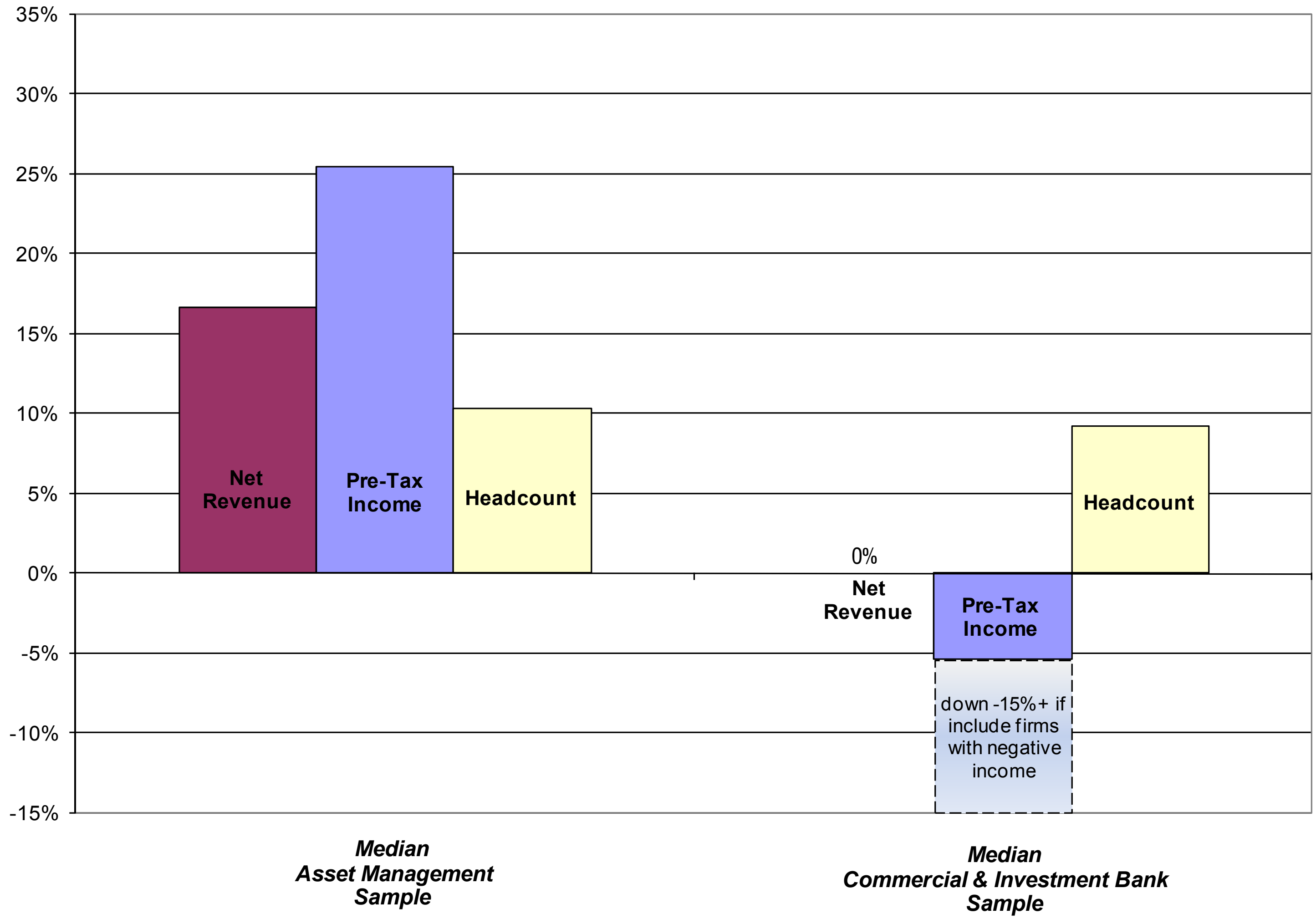
2008 Fearless Predictions

- 2008 will be an old-fashioned terrible compensation year
  - Reduced revenues across major businesses on high cost base
  - Continuing credit problems
  - Incentives down significantly vis-à-vis 2007 (i.e., 30%)

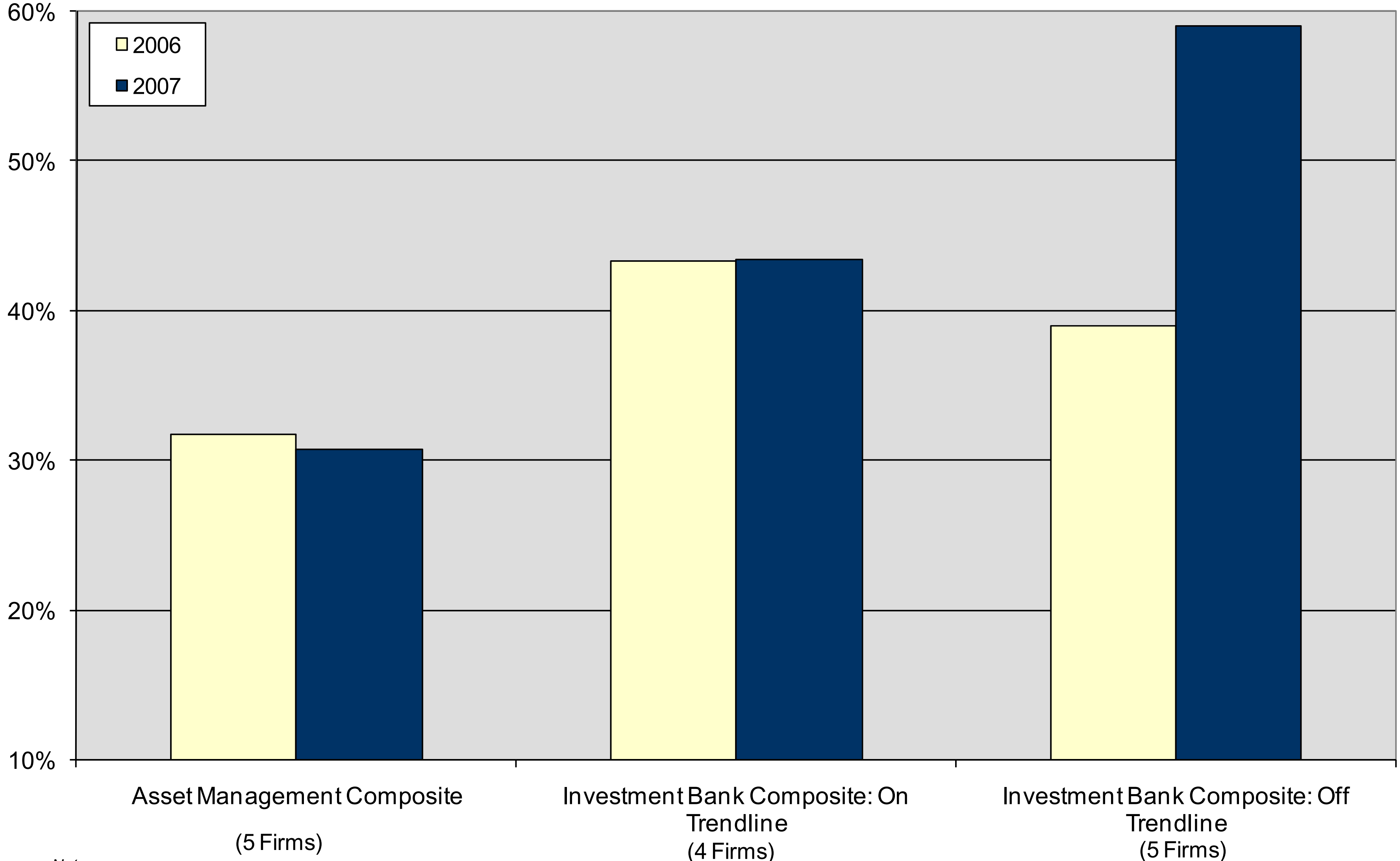
- Business fundamentals weak through 2008
  - Investment banking and equities struggle
  - No trading momentum (i.e., risk aversion and higher cost of capital)
  - Retail brokerage hurt by declines in clients net worth
  - Asset management environment more difficult
  - Prime brokerage slows (i.e., fewer new clients & credit)
  - Commercial/retail banking moderate due to credit issues
  - Hedge fund consolidation begins
  - Tough private equity year-deal flow and portfolio problems

- Significant headcount decrease (i.e., 15% net below 2007 high)

2007 vs. 2006 Changes in Key Indicators

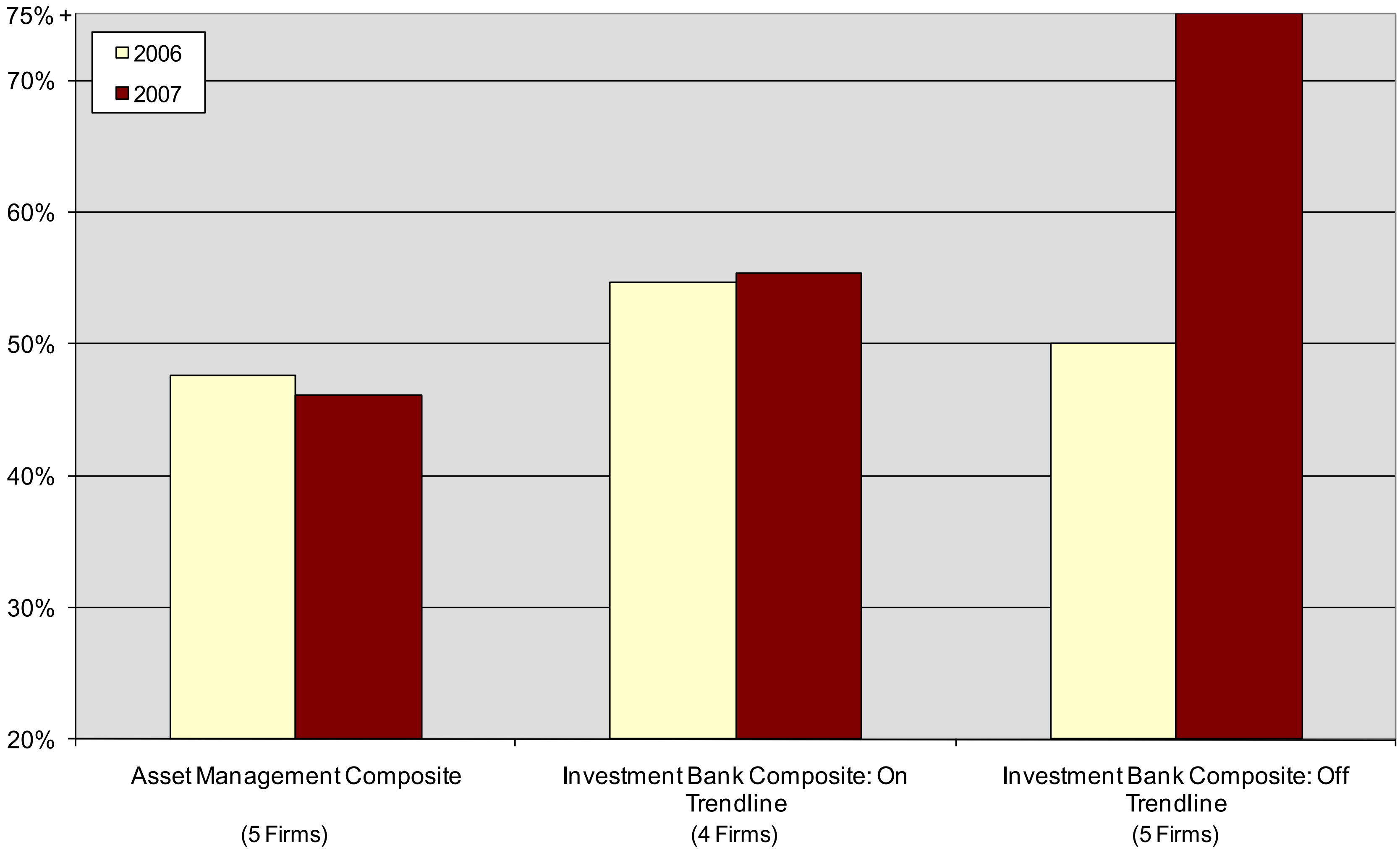


2007 vs. 2006 Compensation as % of Net Revenues



Notes:
Net Revenues include provision for credit losses
Select ratios may be skewed high in 2006 because of the incremental expense for retirement acceleration & SFAS 123R adoption

2007 vs. 2006 Compensation as % of Pre-Tax Pre-Comp Income



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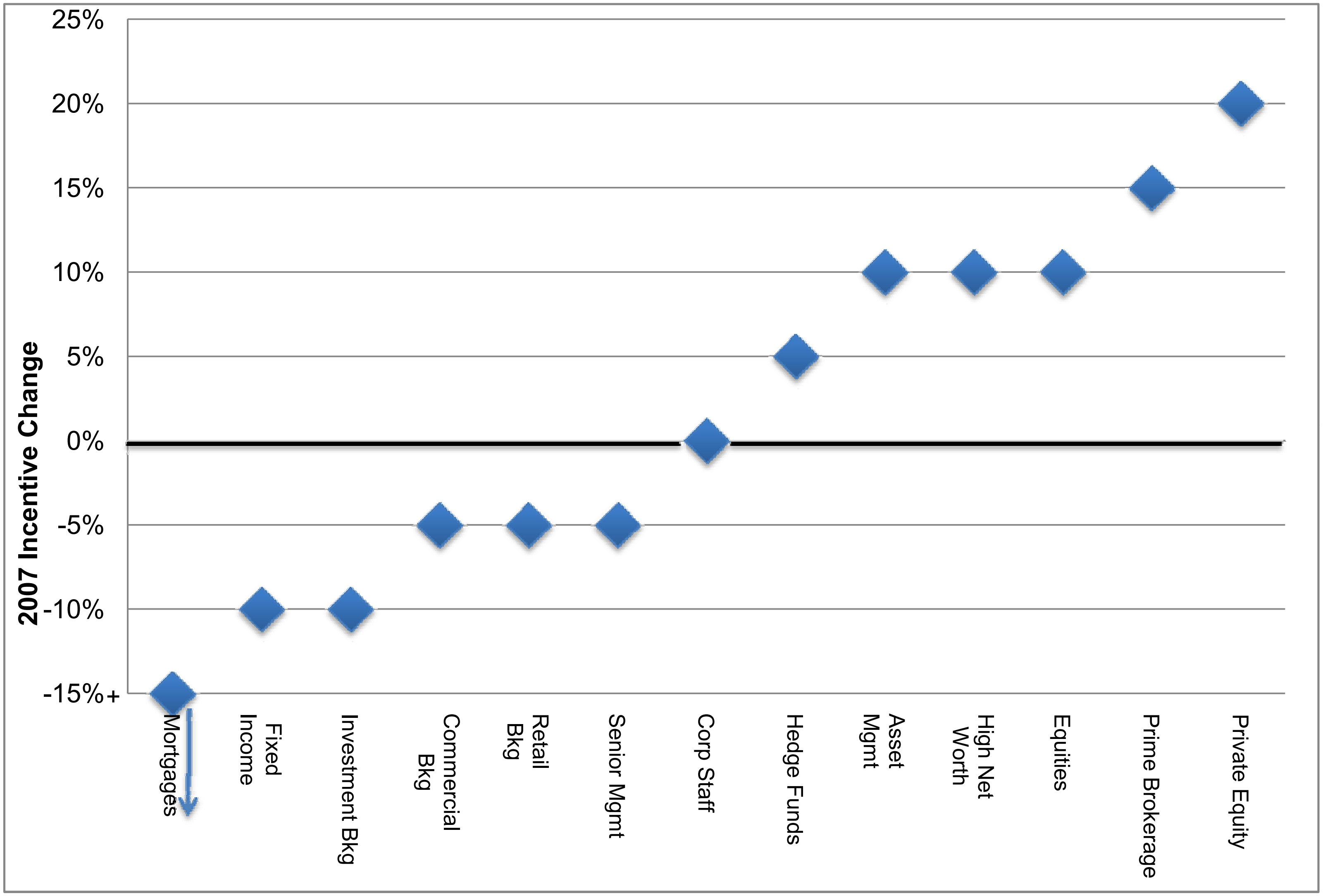
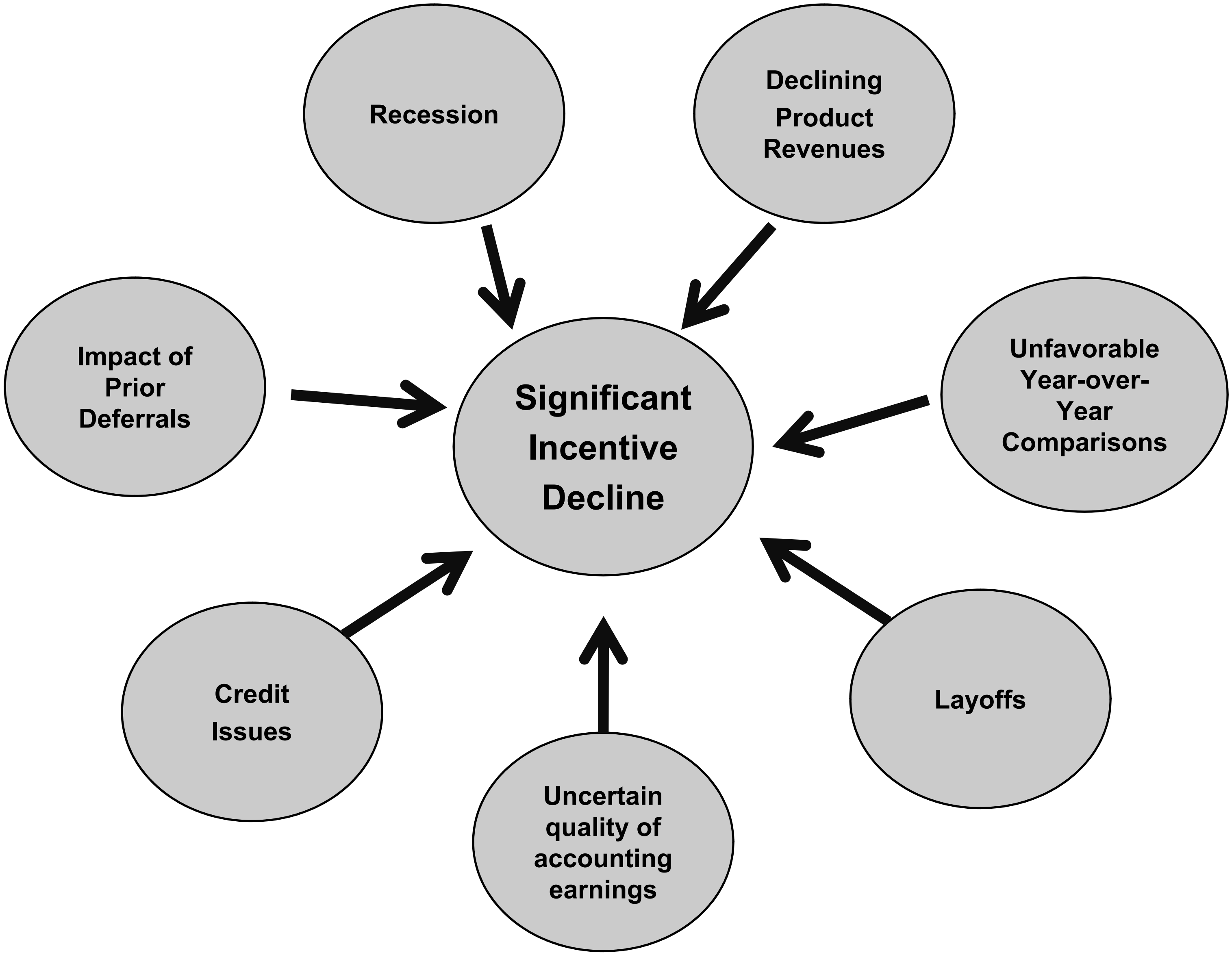
2007 Typical Incentive Changes (Value of Cash Bonus & Equity)



2007 Incentive Funding

- Classic discretionary investment banking model waning
  - More explicit funding on business (i.e., “bottoms up”)
  - Increased information need on comparator practices
- Ensure sensible designs and recognize “netting risk” (i.e., commitments not linked to overall firm results)
  - Large impact as small units created major problems
- Often lack of clear understanding of changing dynamics by Board Compensation Committee
  - Much more difficult to compare aggregate ratios between firms and expectations

Probable 2008 Funding Environment



Long-Term Incentives/Deferrals

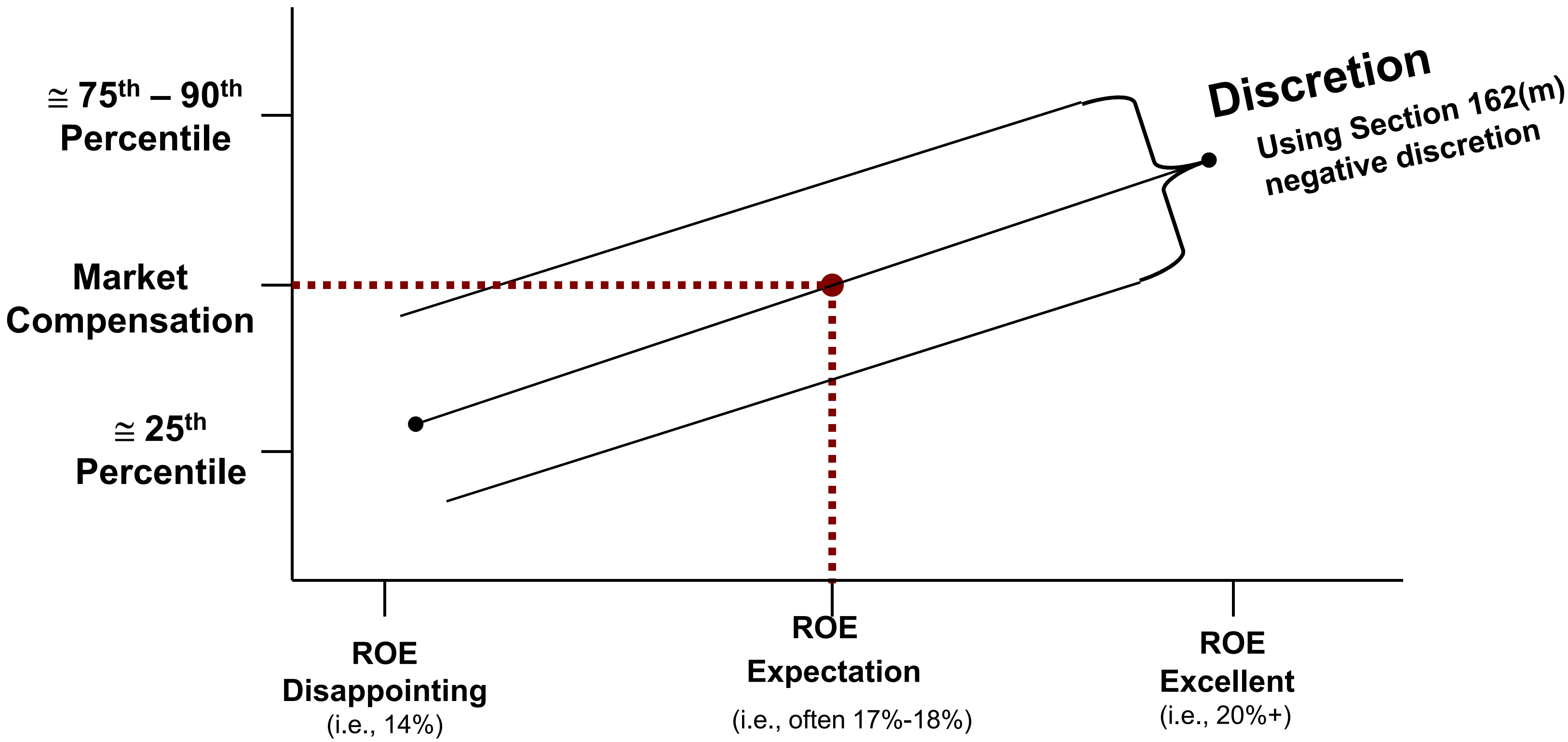
- 2007 and 2008 Year-Ends
  - Major shift to deferrals to increase compensation and retention
  - Increased expense moved forward; medium to large “time bomb”
  - Survey data on mix will not reflect normal practices
- Treatment of layoffs during 2008 is issue
  - Vesting of deferrals will accelerate expense
- Section 409(a) impacts deferral schedules
  - May need to establish deferral schedule by mid-year
- In uncertain times vehicle choice is important
  - Restricted stock for stability
  - More creative approach to help drive business (i.e., long-term awards linked to improvement over 3-5 years)

Governance Issues and Concepts

- Need more <u>significant</u> independent chairmen
  - Oversight and strong views
- Senior executives should lose awards if results vaporize in future
  - One area where corporate critics more right than wrong
- Should have high/very-high levels of internal stock ownership
  - Executives
  - Senior professionals
  - Boards of Directors
- Compensation Committee Chairman role should expand
  - More active involvement and quality input

Executive Compensation Driven by Absolute Returns

- Wall Street executive compensation driven by absolute accounting ROE
  - Absolute returns considered better than projections or budgets
  - Large changes in total compensation normal



- Predict 2008 compensation for proxy executives down 30%+
  - Actual compensation moves closer to norms for broader U.S./U.K executive markets

Sales Compensation

- Broad dissatisfaction with sales compensation
  - Difficulty in attracting assets in competitive market
  - Frustration by firm management as sales cycles longer
  - More complicated products with subtle differences
- Importance of consistency and persistence
  - Need to truly differentiate product
- Narrow focus on "stars" makes hiring difficult and expensive
  - Little real interest in development or training programs
- Accelerating elimination of below average producers
  - Terminations rather than sole reliance on compensation
- Objective compensation dominates
  - Key exception is alternative products where often discretionary and problems with formula-based
- Deferral levels more normal rather than 2007-2008 "jumbo" elsewhere in firm

Investment Banking

- 2007 compensation for senior professionals moderately lower
  - 2008 compensation will decline more significantly (i.e., 30%)
  - No compensation subsidy from trading
- Normal slow period exacerbated by global credit issues
  - Key strategic element of overall firm
  - Internationally important for expansion
- Reached equilibrium in research
  - Two-tiered market of few visible senior professionals and number of lower-level. Few mid-level professionals
  - Buy-side research pay’s better with enhanced careers
  - Unbundling of trading and research
- Meaningful layoffs(i.e., 15%+) reflecting over capacity

Asset Management – Compensation Issues

- Trying to jam asset management into Wall Street pay and business norms creates underperformance
  - Long-tailed business with heavy mix of structured pay
  - With three separate approaches difficult for institutions trying for broad incentive funding or comparability
  - Deferral into funds in lieu of firm equity
- Unit senior management (1)
  - Income based incentive with discretion
  - Budget achievement and “partner” sharing of profits common
- Sales (2)
  - Formalized sales plans with heavy weighting on new assets/retention vs. client service
- Investment management (3)
  - Multi-year returns against benchmarks and peers
  - ≅20% to recognize broader contributions and sales support
  - “Star” portfolio managers have leverage for special arrangements

Private Equity – Times of Trial

- Good long-term business often lacking bedrock support of senior management
  - Current problems will test commitment, selective exits from business
  - Difficulty of recognizing aggregate benefits from business
- Long-tailed businesses and compensation
  - Re-fighting carry design and governance (i.e., vesting, investment decisions, business decisions, etc.)
  - Carry at institutional firms often 10-15 points reflecting firm economics and importance of fund raising support
- Viable aggressive independent competitors drive market
  - Have long time frames and lack pressures of public reporting
  - Without same perceived conflicts-of interest

Hedge Funds – Shakeout Begins

- First real movements away from broad asset class
  - Over capacity and declining returns going forward
  - Short lock-up periods
  - Products oversold into high net-worth accounts
  - Distressed funds now attract assets

- Hedge fund slowing has major impacts on firms
  - Prime brokerage
  - Trading references
  - Investment banking

- Management fee and carry provide impressive economics

- Hedge funds and Fund-of-Funds have different compensations norms
  - Owners/Firm receive greater proportion of economics in F-o-Fs

Bubble Ending in 2008*

- Bubble Definition: when everyone in financial services knows things are unsustainable/crazy but herd instinct, or short-term greed, overrules judgment

Issue		**2008 Situation**	**Hindsight**
Hedge Funds	→	Weakening-investor exodus	✓
Private Equity	→	Bad outcomes in 2008, more in 2009/2010	✓
Real Estate	→	Fundamentals shaken	✓
Interest Rates	→	Higher and rippling through industry	unclear
Consumer Banking	→	Maxed out 2007 second half, carrying into 2008	✓
Mortgages	→	Pain moves from “C” to “B” mortgages; commercial end	✓
Geopolitical	→	Sadly Iraq ends poorly	unclear
Taxes	→	Higher to pay for uncontrolled government spending	✓

ETC.

***From March 2007 presentation to WSCBA**

Summary and Advice

- 2008 will be a very difficult year for compensation
- "Full Bubble Burst"
  - Communicate early with compensation committee
  - Restricted stock and one-time arrangements
  - Heavy deferrals
  - Recognize fluctuating accounting figures
  - Significant layoffs
  - Evaluate severance terms
  - Rethink executive pay paradigm
- More explicit and clear unit incentive funding formulas
- 2008 compensation for proxy executives down 30%+
- Aggressive sales compensation plans and expectations
  - Stress from high net worth due to existing risks
- Wall Street retreats from private equity
- Hedge funds and alternatives under stress
  - Work needed on compensation and business practices

∴ **Financial Services is a good cyclical business that will come back**