Rewind of 2006 Compensation and the Financial Services Bubble

Wall Street Compensation and Benefits Association

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Introduction

Discussion of current compensation issues for financial firms

Johnson Associates

- Boutique financial services compensation consulting firm. Annual and long-term incentive designs, market levels and practices, performance goals/measures, and equity/carry distributions. Independent expertise and in-depth knowledge across comparator groups and labor markets

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

2006 Broad Re-Cap

- Significantly increased compensation versus 2005
  - Fixed income/trading strength and clearly improved investment banking
  - Impact of hedge funds and private equity
- Greater increase in staffing
  - Focus on high-end talent
- Steady compensation accrual rates. Moderating subsidies to investment banking and equities and geographic build-outs
- Bubble compensation pressures building
  - Hedge funds and private equity paying outlier amounts (i.e., more examples of “silly” levels)
- Heavy restricted stock use
  - FAS 123R takes full effect

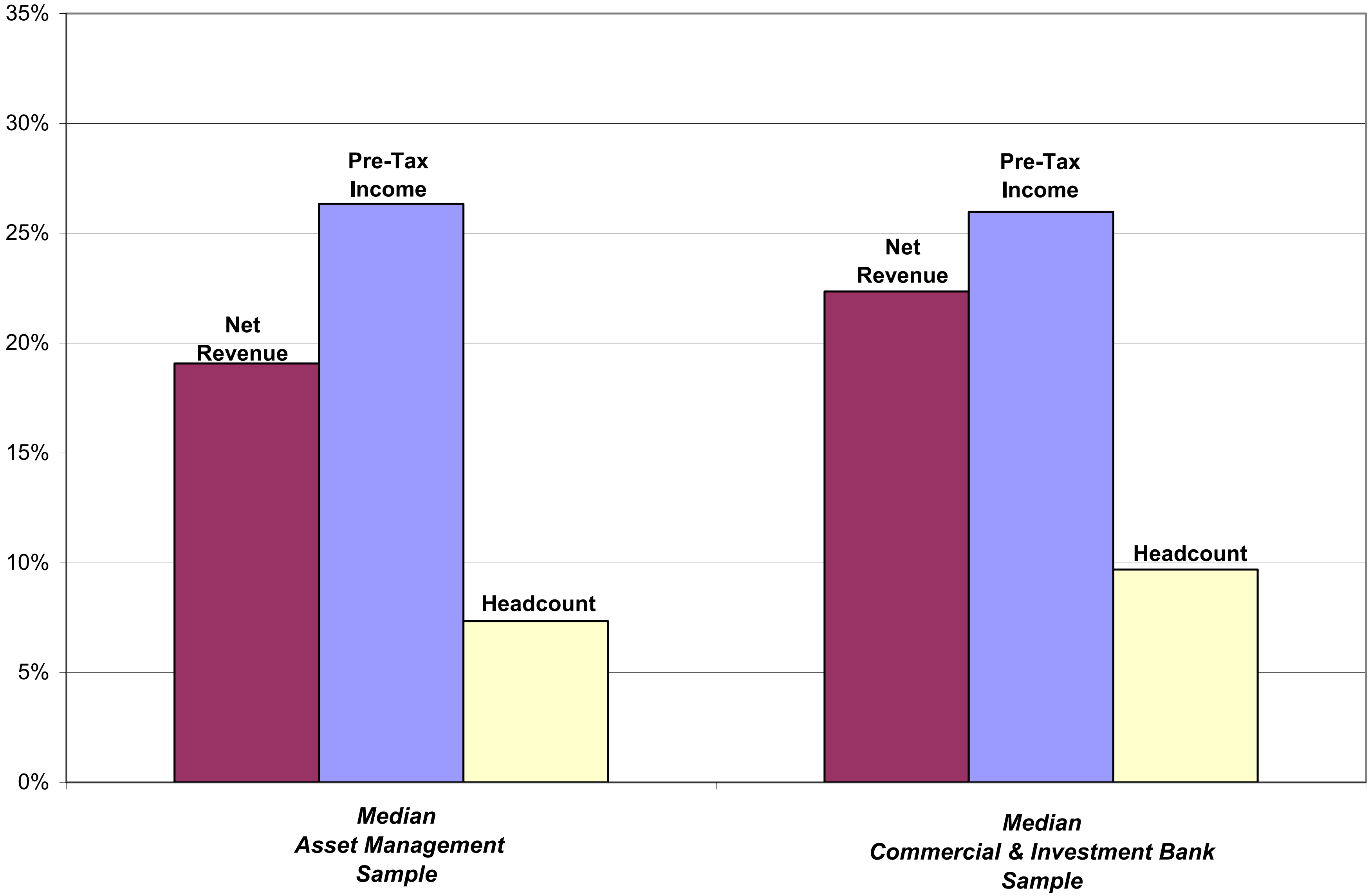
2006 Broad Re-Cap

- Large divergence between major firms and other comparators
  - Careful thinking/analysis more important due to group differences
- Strong competition across high-net worth and asset management
  - Rising markets mask some structural issues
- Greater use of gardening leave and selective non-competes
  - Clearly, philosophy has yet to evolve
- Independent Hedge funds/Fund-of-Funds/Private Equity serious talent threats at margin. Alternatives established as long-term asset class
  - Hiring for both front and back-office
  - Their compensation analyses include broader firms
- Cost-of-living differences clear issue in compensation
  - London costs driving perception/reality of higher compensation
- MGMC purchase (Feb. 2007) by Towers Perrin should solidify/expand data offerings

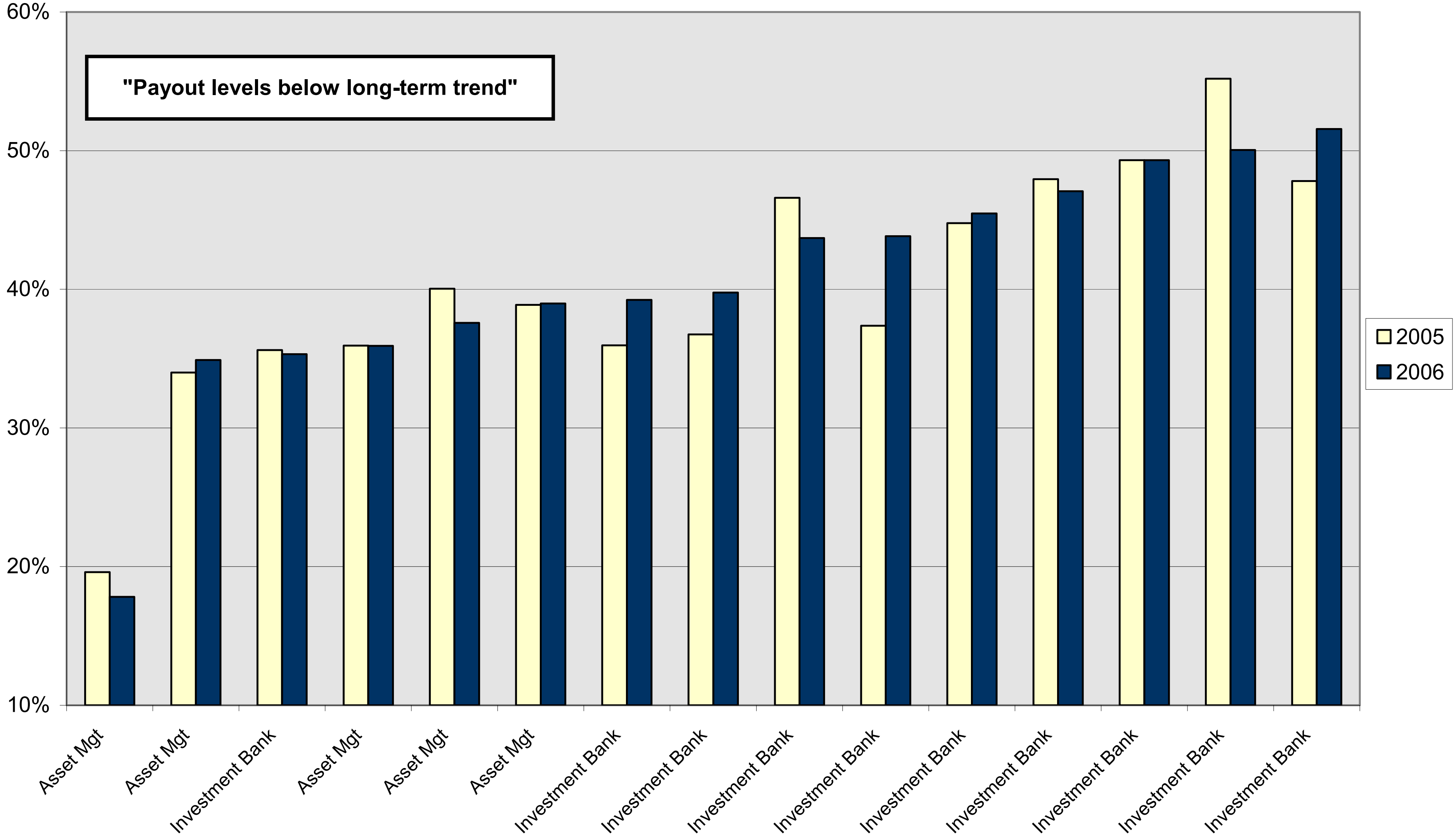
2007 Fearless Predictions

- Bubble will <u>not</u> burst in 2007 but signs are there
  - Last gasp before reckoning
- Business fundamentals strong through 2007
  - Rebound in investment banking and equities moves forward
  - Trading momentum continues (i.e., yield curve and risk overwhelmed)
  - Retail brokerage benefits from 2005-2006 stock market
  - Asset management environment better, but institutions lag
  - Commercial/retail banking moderate due to mortgages and credit issues
  - Amazing rush to alternatives continues
- Return of multi-year guarantees (and associated issues)
  - 2000: “3x3” (years x $ million)
  - 2007: “3x5”
- Significant headcount increase (i.e., 5-10% net above year-end 2006)
- Investment Banking pay increases significantly <u>again</u> (i.e., 20%+)

2006 vs. 2005 Changes in Key Indicators

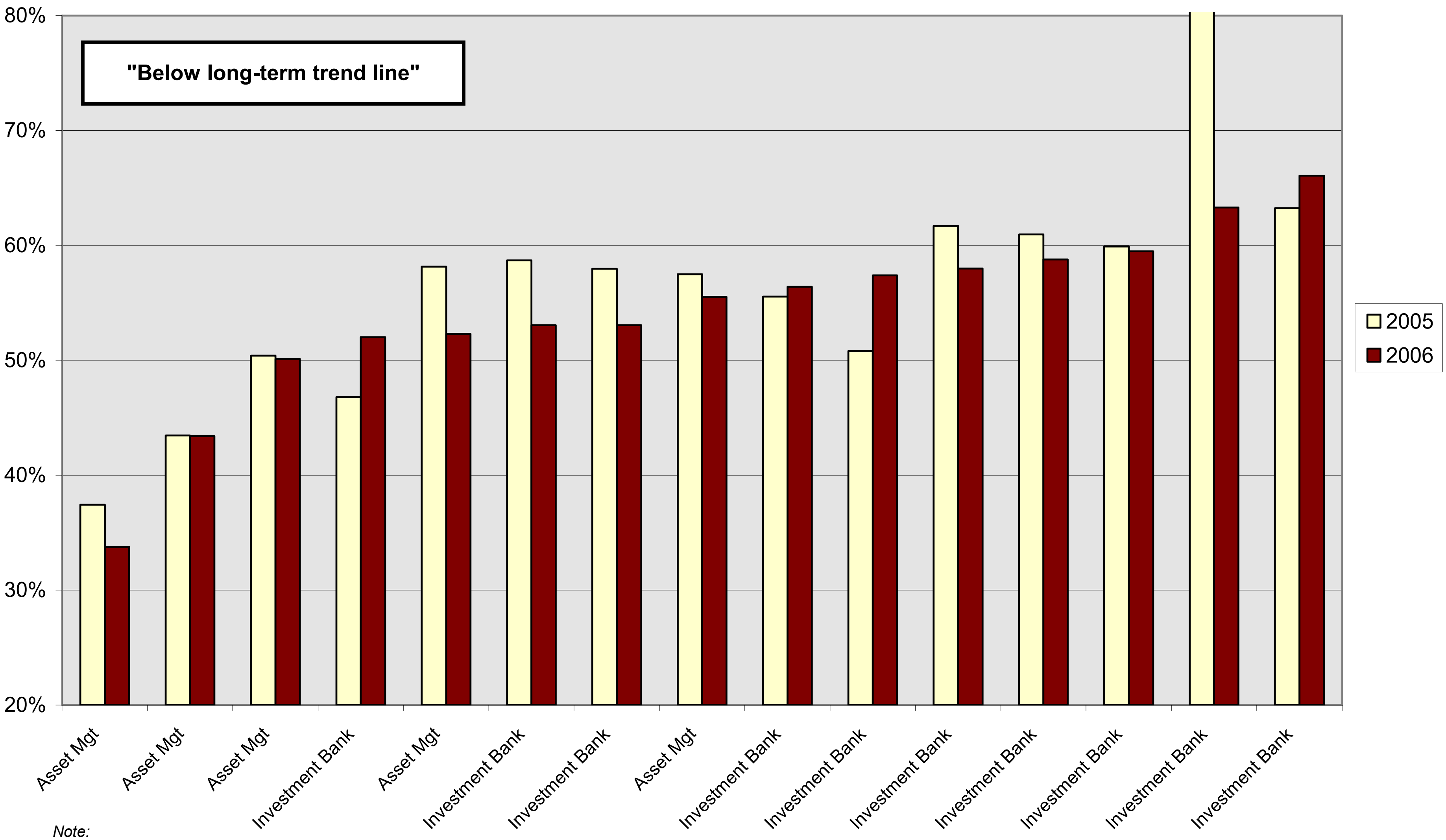


2006 vs. 2005 Compensation as % of Net Revenues



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

2006 vs. 2005 Compensation as % of Pre-Tax Pre-Comp Income



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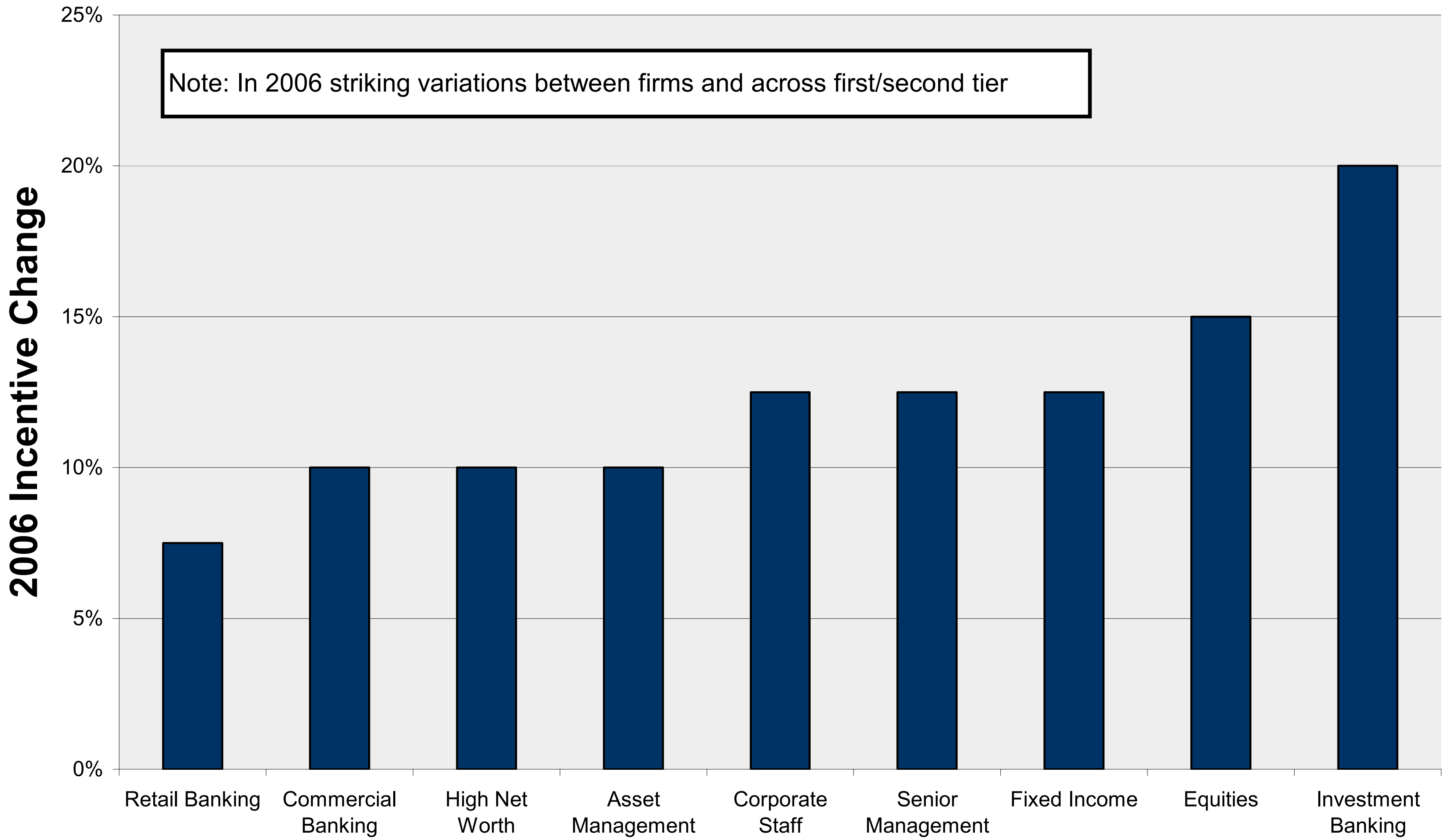
2006 Typical Incentive Changes (Value of Cash Bonus and Equity)

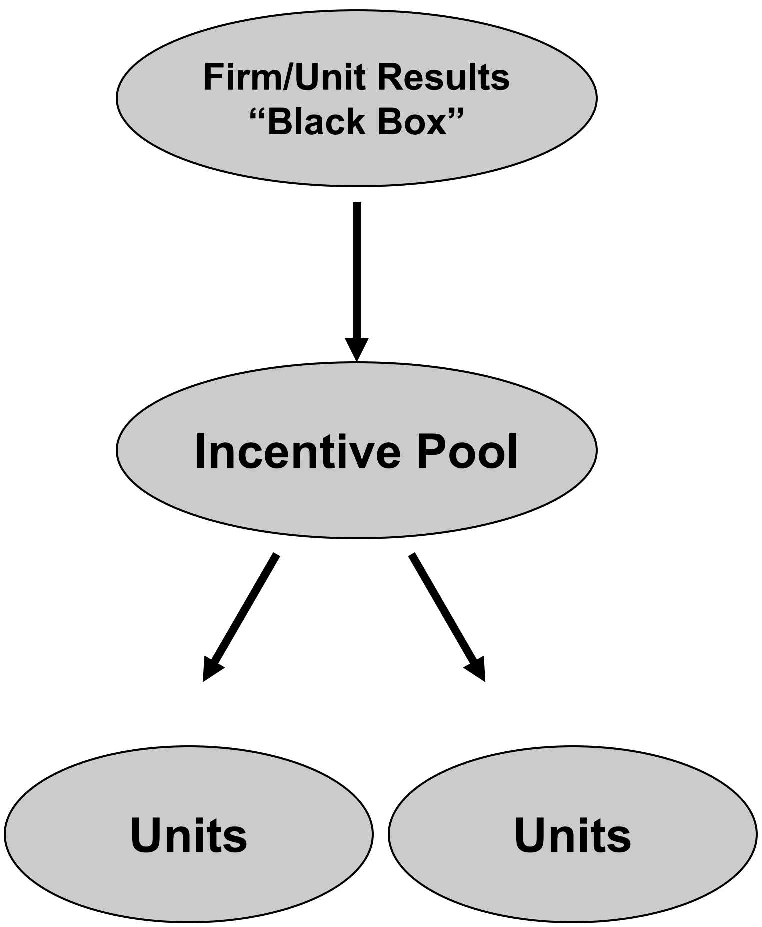


Incentive Funding Evolution

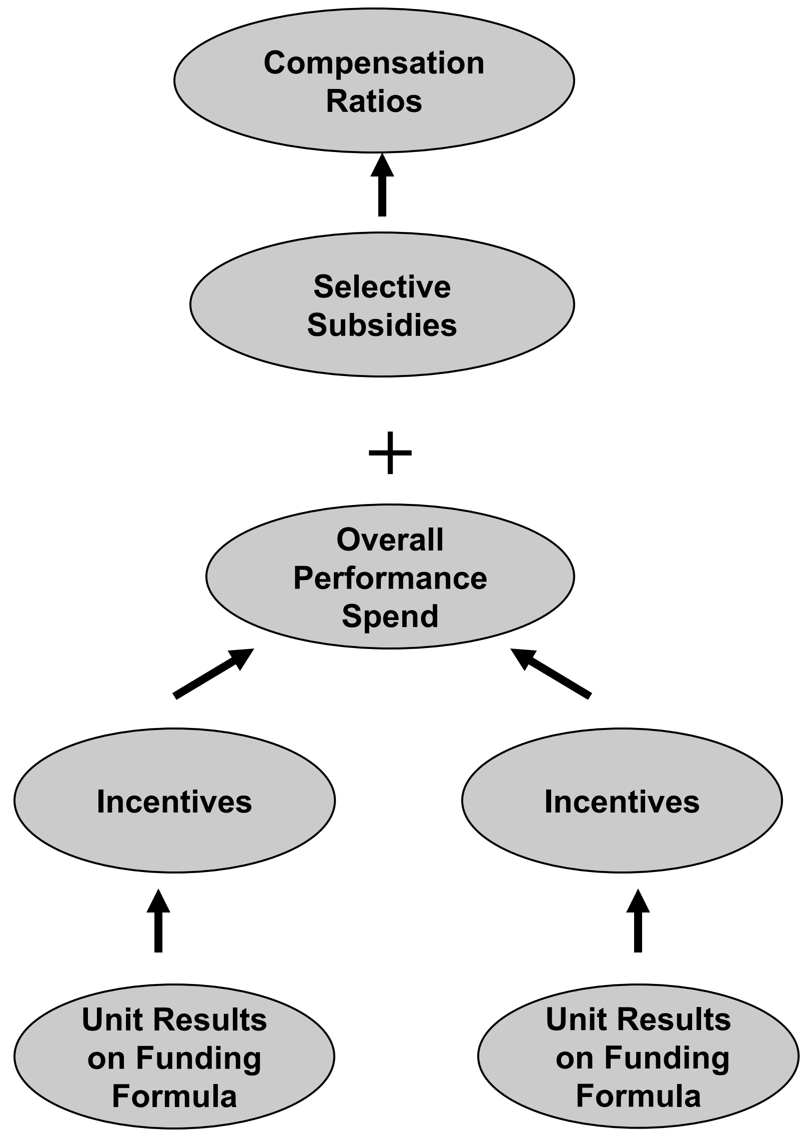
- Classic discretionary investment banking model waning
  - More explicit funding on business/unit (i.e., more "bottoms up")
  - Increased information need on comparator practices
- Firm size and business diversity driving changes
  - Size can have major advantages
- Ensure sensible designs and recognize "netting risk" (i.e., commitments not linked to overall firm results)
- Often lack of clear understanding of changing dynamics by Board Compensation Committee
  - Much more difficult to compare aggregate ratios between firms
- Alternatives and asset management increase need for objective programs
  - More leveraged pay curves to recognize results

Illustration of Funding Evolution

Historical Model



Results Based Model



Long-Term Incentives

- Overly heavy use of restricted stock reflecting accounting advantage elimination for stock options
  - Stock settled SARs overtime replace stock options
- Heavy equity orientation slipping due to impact of ISS
  - Shareholder alignment key for senior professionals
  - At current compensation, equity %'s should be higher
- For diversified firms, effective use of single stock difficult
  - Importance of line of sight vs. joint effort
  - Deferrals into funds by asset management participants
- Continuing towards more sensible termination provisions
  - Leaving industry receiving more favorable treatment

Equity Alternatives For Enhanced Leverage*

- Indexed stock options (turn-around/private/out-perform)
  - Exercise price adjusted up or down, for movements in comparator prices
  - Receiving 2x+ number of options provides leverage and reduces impact of broad market movements
  - Requires clear comparator group

- Barrier stock options (start-up)
  - Not exercisable until a high future price achieved
  - For example, current price $125 and barrier of $240. <u>If</u> and <u>only</u> if $240 reached, gain back to original $125

- Performance restricted stock (turn-around/out-perform)
  - Earn variable number of restricted shares on absolute or relative financial results (i.e., ROE)

* Examples of alternatives under new accounting

Return of Co-Investment

- Broad co-investment is cyclical pay practice now returning in alternatives currency
  - Private equity flavors
  - Hedge funds
  - Real Estate

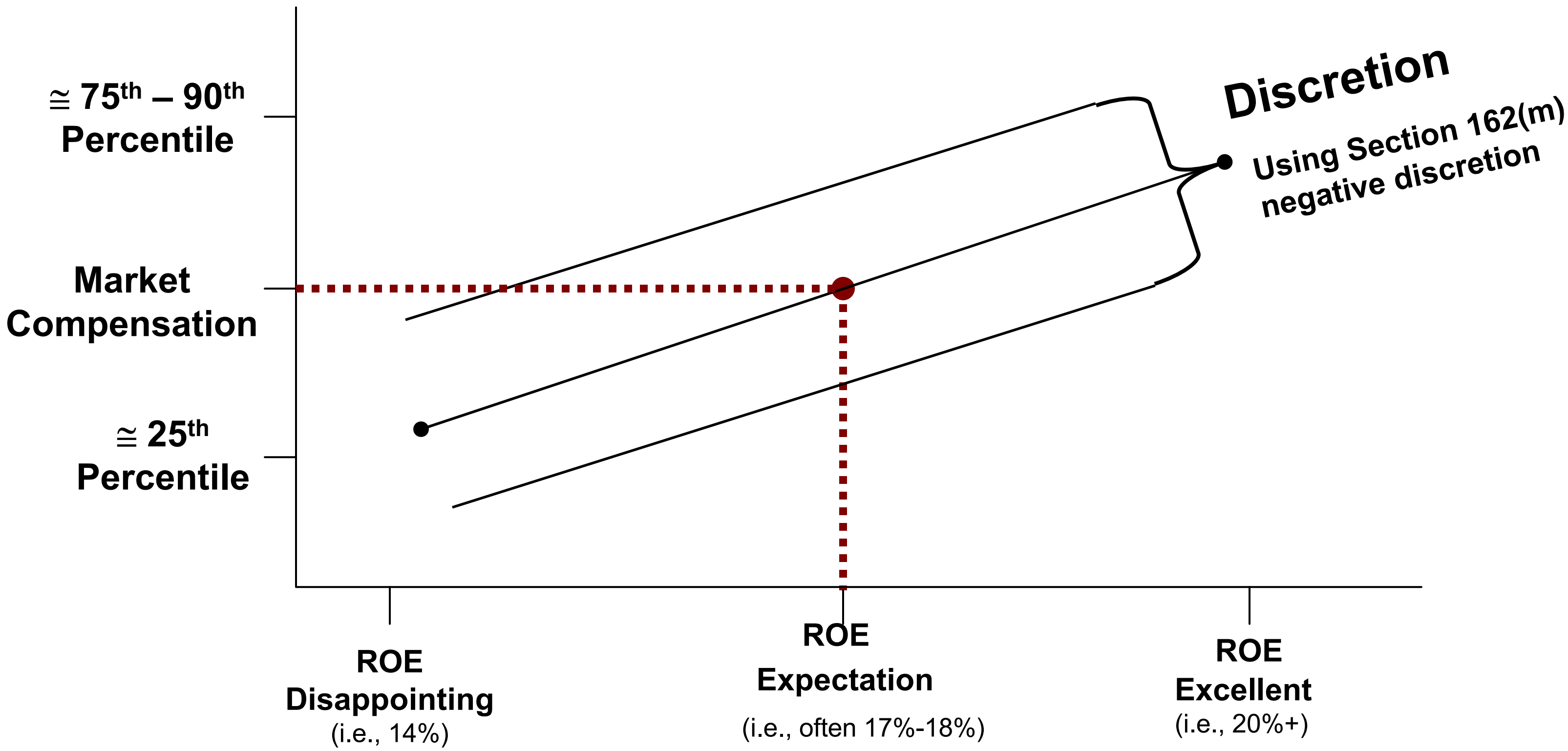
- Amnesia on loses from 1999-2001 co-investment vintages
  - Is this really the time to be doing this?

- Provides substitution for portion of firm equity and replacement for commitment to alternative funds
  - Diversification
  - Funding source to jump start new products

- Standard terms (non-officers)
  - 1-3x leverage
  - 50% recourse (has typically been sufficient)
  - Funding cost plus 50 basis points
  - 3-4 year vesting on gains; always vested in loses
  - Annual participation

Executive Compensation Driven by Absolute Returns

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



- Predict 2007 compensation for proxy executives up 10%
  - Business momentum and no visible ceiling on pay

Sales Compensation

- Challenging sales compensation across brokerage/high-net worth/asset management sectors
  - Difficulty in attracting assets in competitive market
  - Frustration by firm management as sales cycles longer
  - More complicated products with subtle differences
- Firms providing <u>aggressive</u> up-front payments for proven talent
- Narrow focus on “stars” makes hiring difficult and expensive
  - Little real interest in development or training programs
- More aggressive elimination of below average producers
  - Terminations rather than sole reliance on compensation
- Objective compensation continues to dominate
  - Key exception is alternative products where sales often discretionary and problems with formula-based compensation
- Increased deferral levels more akin to firm wide plans

Investment Banking

- 2006 compensation for senior professionals significantly higher
  - 2007 compensation will also increase significantly (i.e., 20%)
  - Vanishing compensation subsidy from trading

- Businesses are "good" again driven by U.S. and International markets
  - Key strategic element
  - Internationally important for expansion

- Reached equilibrium in research
  - Two-tiered market of few visible senior professionals and number of lower-level. Increasingly few mid-level professionals
  - Buy-side research pay's better with enhanced careers
  - Unbundling of trading and research

- Meaningful hiring (i.e., 10%+) reflecting capacity constraints
  - Exaggerated compensation in hiring attractive entry professionals

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 regaining leverage for special arrangements

Private Equity - Amazing Rebirth

- Increasing emphasis, on private equity, venture capital, and real estate
  - Lag in compensation vis-à-vis independent competitors
  - Firms now recognize they need product for high-net worth with fuzziness on attribution for related fees
  - Mega funds increasing compensation at high-end

- 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 perceived conflicts-of interest

Hedge Funds

- New issue for institutional firms hedge fund liquidity. Pressure for ownership by professionals
  - Business dominated by independents who provide ownership beyond founders
  - Variety of practices reflecting explosive growth and founder DNA
  - Measuring at fund/product/firm level has crucial impact on risk and culture
  - Need blend of transparency, stability, and flexibility
  - Broad equity ownership usually beneficial
  - Disagreements on basics (i.e., "my friends don't have vesting…")
- Management fee and carry provide impressive economics

Illustration of Independent Hedge Fund Dynamics

- $3 billion hedge fund (medium sized)
- 15% net return with 20% carry
- Senior partner total compensation = $35 million
- 8 others partners = $4-$20 million

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

Financial Services 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**
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
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
Taxes →	Higher to pay for uncontrolled government spending
	ETC.

Summary and Advice

- 2007 will be another year of increasing compensation and results
- "Prepare for Bubble Burst"
  - Restricted stock rather than stock options
  - Avoid multi-year guarantees unless linked somewhat to production
  - Moderate hiring in U.S./E.U.
  - Understand/address exposure to alternatives
  - Accelerate international expansion
  - Reconsider co-investment strategy
  - Evaluate severance terms
- More explicit unit incentive funding formulas
- 2007 compensation for proxy executives up 10%
- Aggressive sales compensation plans and expectations
- Wall Street bungled asset management and private equity
  - Getting second chance due to rising markets
- Hedge funds and alternatives
  - Work needed on compensation and business practices

∴ **2007 will be interesting/good year, followed by much tougher 2008**