

2008 Compensation and Required Paradigm Shift

Wall Street Compensation and Benefits Association

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- Discussion of current compensation issues for financial services firms

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Johnson Associates

- Independent financial services compensation consulting firm. In-depth expertise and candor across businesses and labor markets. Sound practices and philosophy, incentive designs and goals/measures, market levels and funding, and equity/carry distributions
- Diverse Clients
 - Investment and commercial banks
 - Asset management firms
 - Hedge funds/Private Equity/Alternatives
 - Insurance companies
 - Brokerage firms
 - Trading organizations

Profound Changes Requires Paradigm Shift

- Disaster in financial services requires significant changes:
 - Substance of programs and approaches
 - Perceptions by regulators/politicians, press, shareholders, and employees
 - Unhelpful nomenclature
- Complicated , expensive business models unsustainable
 - Far too many expensive professionals (i.e., on support side 40% above \$500k too many)
 - Overstaffing generally (i.e., 20%)
 - Offices, products, and technology
- Continuing global government influence
 - Compensation and spectrum of other issues
- Compensation mix evolves
 - Base salary and incentives

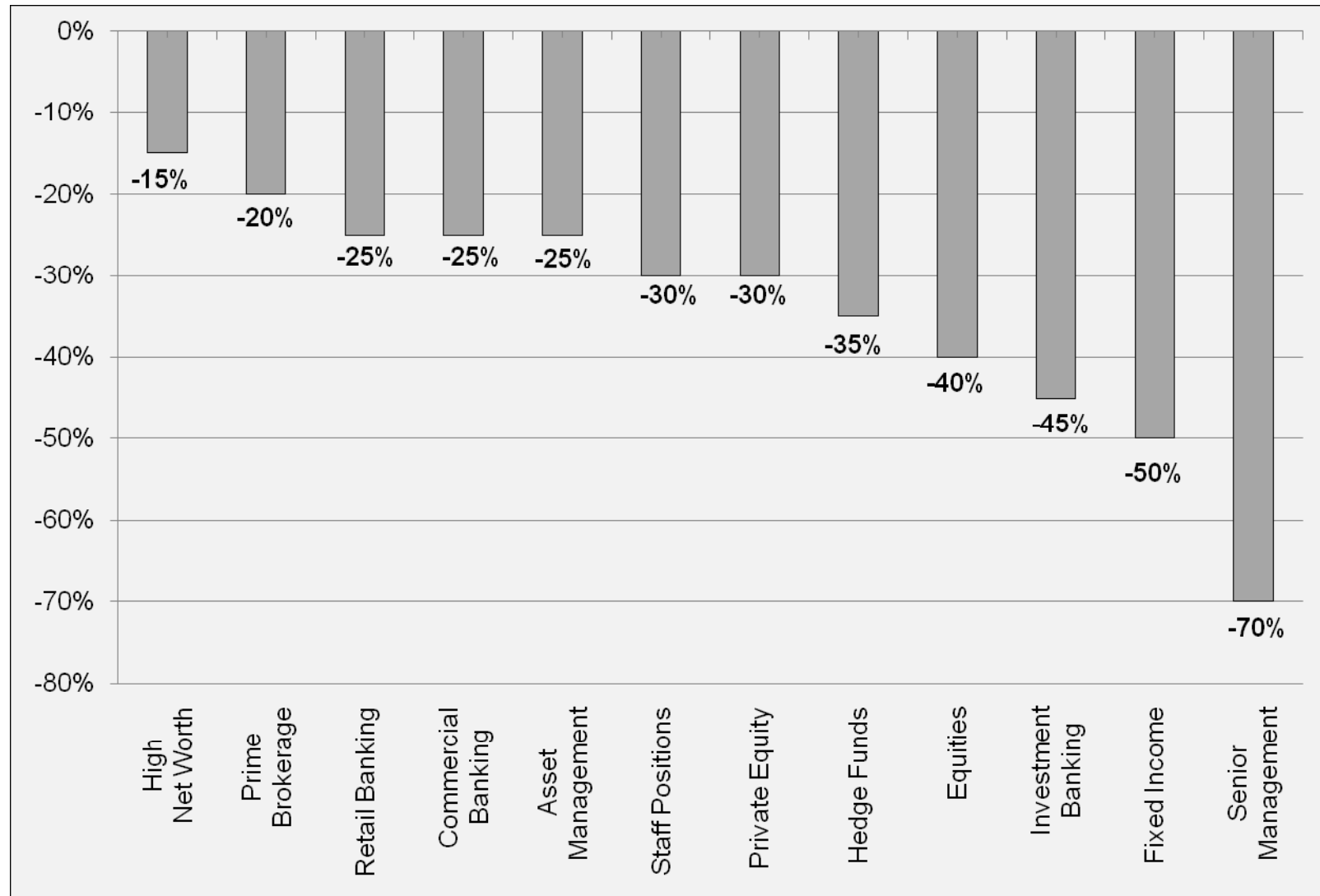
2008 Broad Re-Cap

- Dramatically reduced compensation versus 2007
 - Significant reductions across virtually all businesses and support
 - Many firms paid above aggregate levels earned from performance. Impact of mergers/government support
- Overstaffing continues to unwind
- Difficult and erratic year-end process
- Awards of restricted stock and “one-time” grants
 - Extra large deferrals as part of needed compensation
 - Incremental expense continues to be pushed into future
- Beginning of direct government involvement
 - Continuing oversight and questioning of compensation magnitudes and approaches

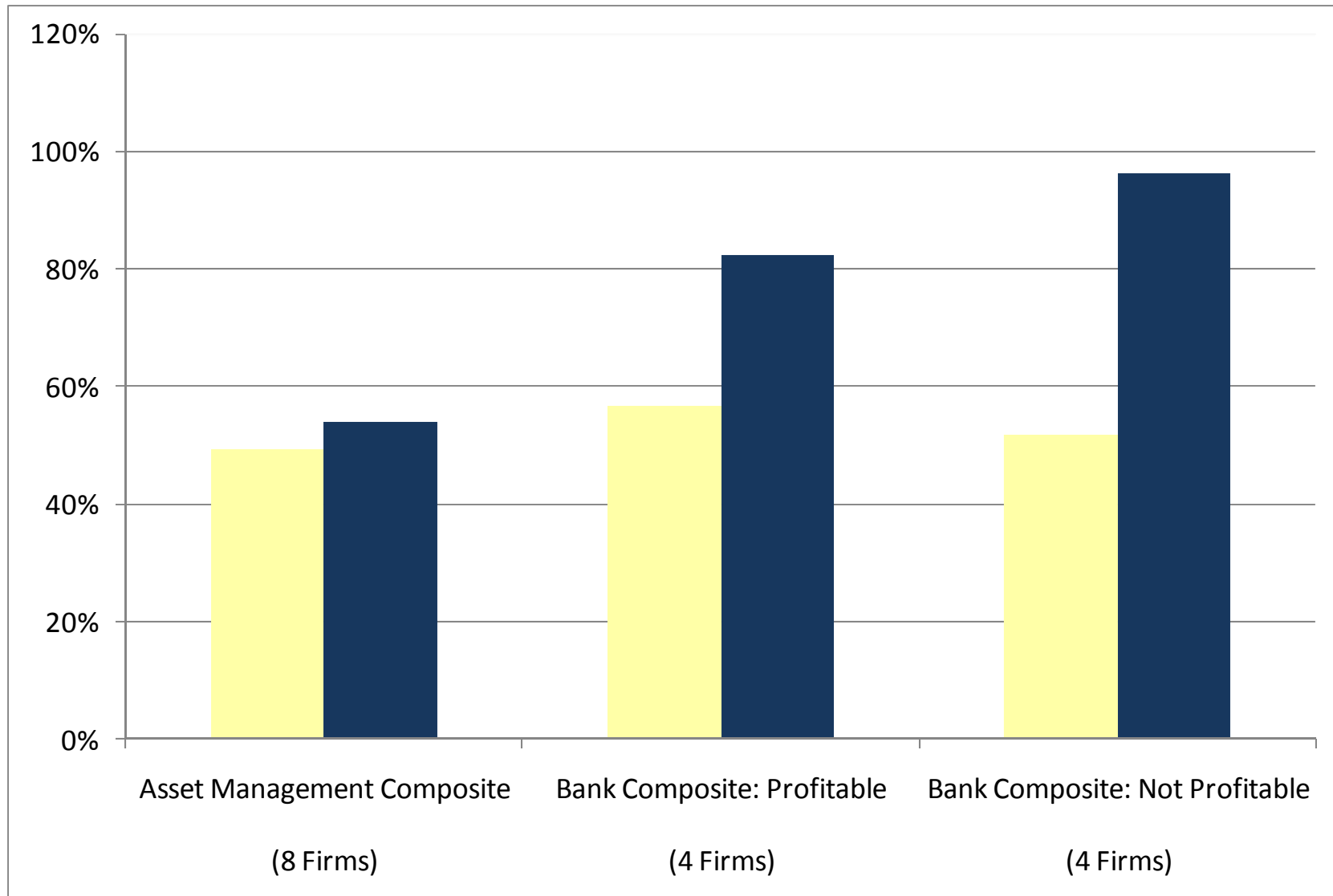
2008 Broad Re-Cap

- Massive and continuing breakdowns in risk and governance
 - Hundreds of billions, at least, of losses as yet unrecognized
 - Enron-type accusations and implications
 - Industry tone deaf regarding government and public relations
- 2008-2009 collapse of high cost asset management model
 - Excessive number of funds, strategies, and products
 - Role of alternatives comes into question
- Credit disaster continued to obscure dramatic slowing in core businesses
 - October 2007-March 2009 has clearly been slow period
- Significant questioning of broad pay paradigm
 - “How can firm lose billions and still pay...?”
 - Need to have more durable and transparent models

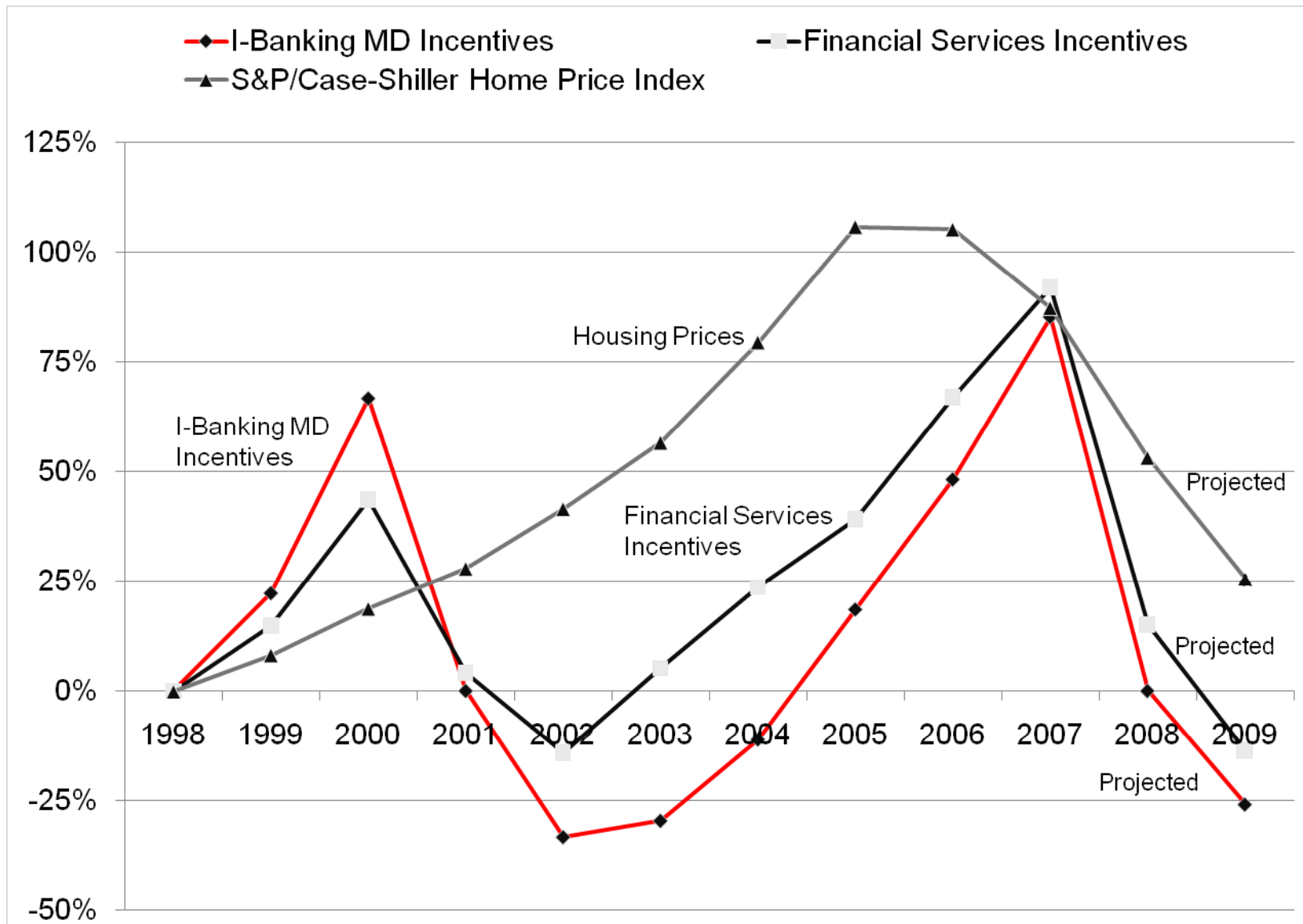
2008 Typical Incentive Changes (Value of Cash Bonus & Equity)



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



Incentives from 1998-2009



2009 Fearless Predictions

- 2009 will be another poor compensation year
 - Reduced revenues across major businesses on high cost base
 - Continuing and new credit problems (i.e., credit cards, car loans, alt-A mortgages, private equity, commercial real estate, subprime mortgages, business loans, etc.)
 - Incentives down significantly vis-à-vis 2008 (i.e., 20%)
- Business fundamentals weak for all of 2009
 - Investment banking and equities struggle
 - No trading momentum (i.e., risk aversion and higher cost of capital)
 - Retail brokerage hurt significantly by declines in clients net worth
 - Asset management environment extremely difficult
 - Prime brokerage in free fall (i.e., reduced assets and leverage)
 - Commercial/retail banking with credit issues
 - Hedge fund shakeout continues
 - Private equity portfolio problems loom large
- Significant headcount decrease (i.e., 15% -20% below 2008 high)

Incentive Funding-Change Ahead

TODAY (2009)

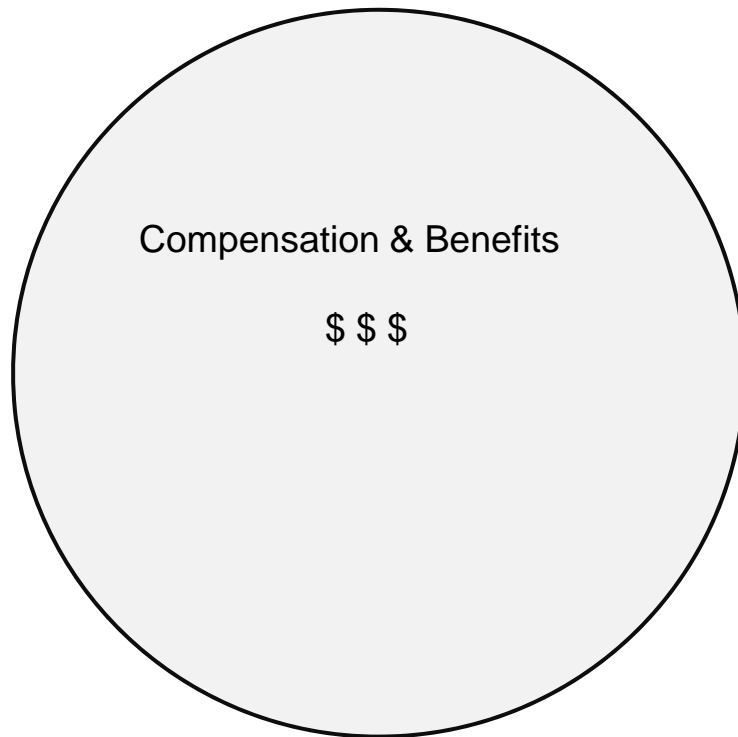
- Discretionary
- Market driven
- Accruals by business
- Unclear compensation philosophy
- Totally unexplainable to external audiences
- Failing to adequately address risk and clawbacks

FUTURE (2010 and Beyond)

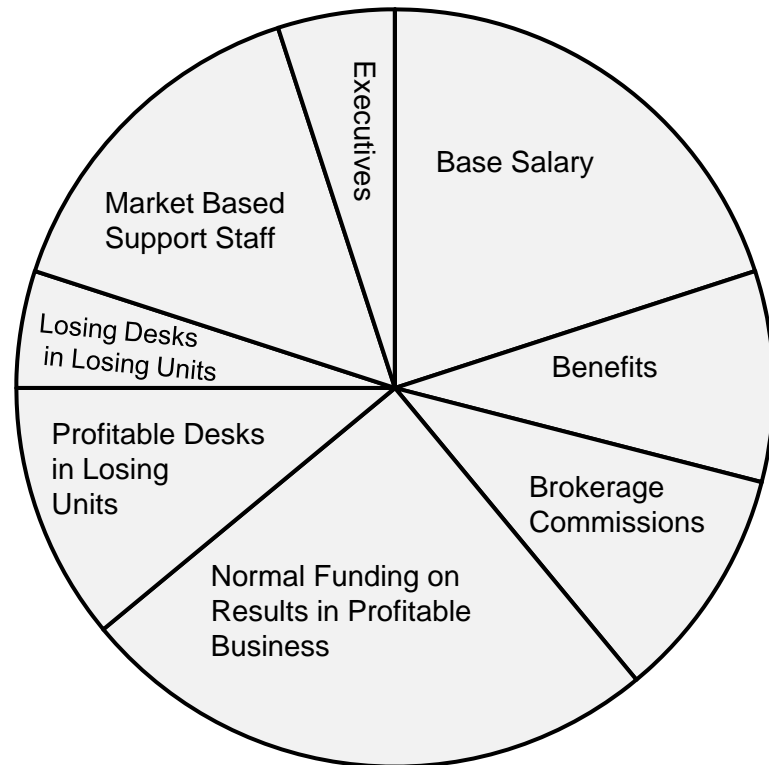
- More objective
- Market focused
- Flexible formulas by business
- Clear compensation philosophy
- Program explainable, and explained, to external audiences
- Hopefully rational risk and clawback provisions

Compensation Transparency and Communication

Today (2009)



Future (2010 & Beyond)



Current model cannot be explained or justified. It is necessary to have compensation system that is both rational and can be explained and defended.

Base Salary Levels – Finally Progress

- Long-standing artificially low base salaries remarkably unhelpful
 - No one believes major financial services firms don't have fixed costs
 - Larger incentives to makeup for base salaries (i.e., 2x shortfall)
 - At odds with desired risk profile
 - Inflates incentive pools and need to justify to external audiences

- ∴ Benefit impact of base salary increases are moderate/plans can be modified

Clawbacks and Risk Adjustments

- Compensation clawbacks mentioned repeatedly in regulator reports/legislation
 - Appropriate for violating legal or risk standards
 - Difficult to recognize future losses due to shared decision making / selective application documentation
- Best broad “clawbacks” can involve three fundamentals:
 - Heavy stock ownership by professionals
 - Plain vanilla stock options (i.e., “poor mans” adjustment for future income declines)
 - Stock retention beyond termination for senior executives
- Risk adjustments difficult to implement formulaically
 - Risk fiendishly hard to measure before-the-fact
 - Key subjective component for incentive pools

Executive Compensation

- TARP compensation rules are destabilizing
 - Ever changing and unpredictable
 - Penalizing firms vs. rational practices
 - Limiting highest-paid employees is problematic
 - Recruiting targets for non-TARP impacted firms
- Nationalized firms at major disadvantage
 - Difficult to pay anyone at high levels due to political dynamics
 - Unofficial U.S. nationalizations at same disadvantage
- If able, need to develop viable strategy for year-end 2009
 - Environment may well remain toxic/unpredictable
 - Consider mid-year awards

Long-Term Incentives

- Very heavy deferral rates continue
 - Significant accruals from 2007-2008 hit financials
 - Need planned approach addressing amounts and vesting
- Badly shaken confidence in firm equity as attractive holding
 - Equity will be restricted stock and “one off awards”
 - Stock options out of favor due to high Black Scholes (volatility) , but good for “clawback” advantages
- For large diversified firms, effective single stock difficult
 - Deferrals into funds by asset management participants
 - Fund ownership by alternative professionals
 - Growth of subsidiary plans
 - Grants into asset pools
- More sensible and specific termination provisions
 - Finally addressing early retirement issues

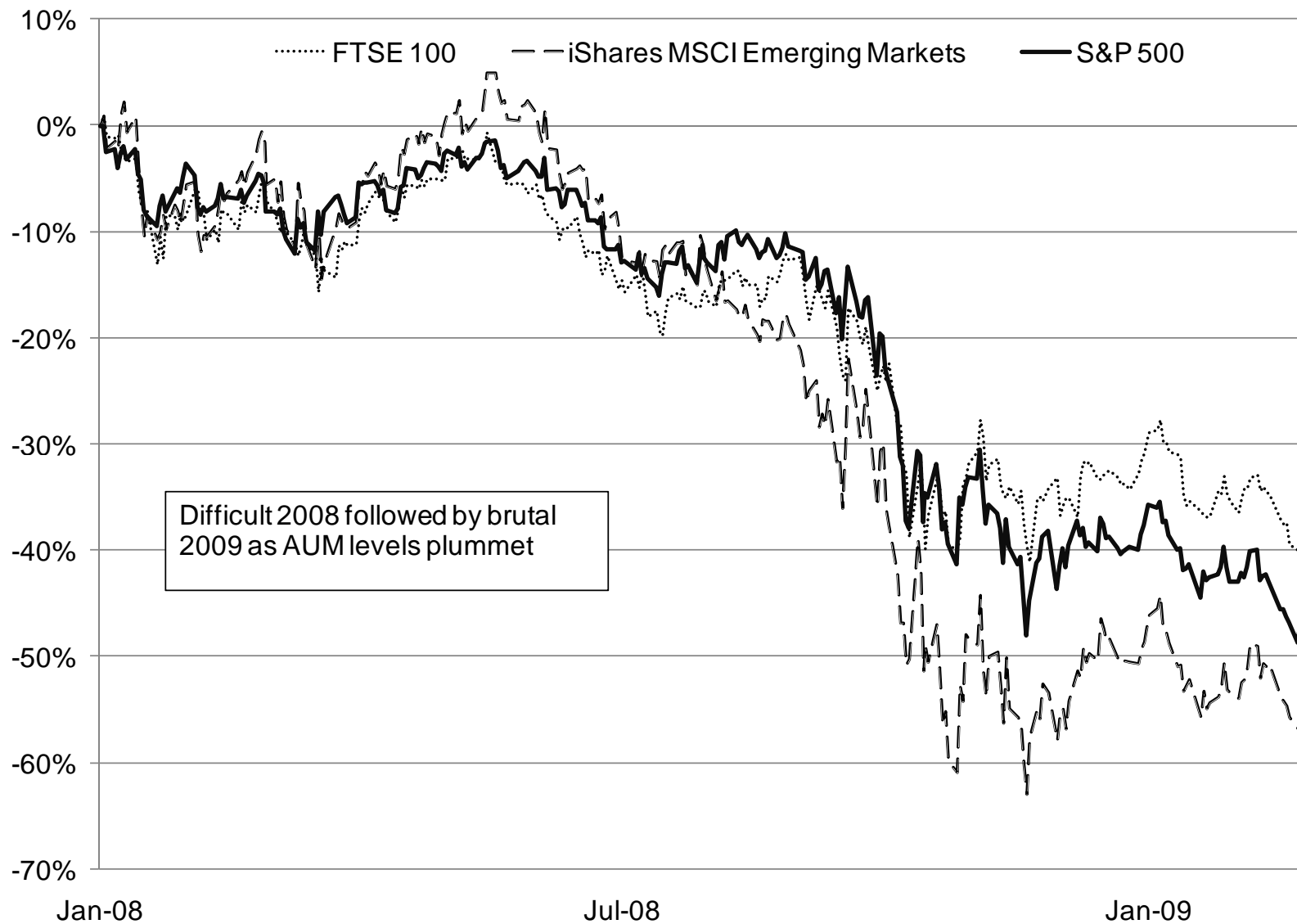
Investment Banking

- 2008 compensation for senior professionals much lower
 - 2009 incentive compensation will decline again (i.e., 20%)
 - Subsidy from trading gone – must be viable on own revenues
- Weak pipeline in 2009 on built-out teams and resources
- 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
 - Resizing the “factory” rather than trimming at the margin
 - Fundamental reassessment of business prospects

Asset Management

- Dramatic drop in 2009 revenues drives major incentive decline
 - Down 40%+ from 2008
- 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 for incentives
- Investment management
 - 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
 - Investor and consultant requirements
 - Lure of independent firms

Asset Management



Private Equity – Significant Problems

- Major structural problems in industry
 - Questionable transactions completed and huge funds raised
 - Carry in new funds generally underwater
- 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
- Difficulty in financing new transactions
- 2005-2008 investment vintages will suffer major losses and sweep in brand name funds. Transaction debt trades at large discounts. Major spillover to fund-of-fund investors

Hedge Funds – Bubble Burst Continues

- Hedge Fund returns down $\cong 20\%+$ in 2008
 - Exposes real value proposition and importance of leverage
 - 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 or simply a fee schedule looking for investors
 - Perverse impact of “high-water mark”
- Important to have viable 2009 pay model
 - Many firms have to reconsider historical pay practices
 - May require firm principals to operate firms at loss in 2009-2010
 - Need to be creative with “high-water mark” problems
- Design details such as measuring results at fund/product/firm level has crucial impact on potential risk profile and culture
 - Need to have blend of transparency, stability and flexibility

Summary and Advice

- 2009 will be another difficult compensation year
 - Major changes needed to compensation paradigm
 - Initial indications mixed at best
 - Must have explainable program
 - Compensation /Human Resources must be proactive
 - Help avoid morale killing initiatives
 - Communications with compensation committee and external audiences must improve
 - Executive compensation under unprecedented scrutiny
 - Changing rules and perspectives
 - Clearer but flexible unit incentive funding
- ∴ Once in a generation series of challenges that must be aggressively and quickly addressed