

# **Compensation & Business Transition Continues: 2010 Mixed with 2011 Distractions**

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**PRESENTATION AND DISCUSSION**

**October 26, 2010**

# Introduction

Johnson Associates	3
2010 Year-End: Focus on Industry Sectors & Areas	4
Mixed Incentive Trends	5
Lessons from Compensation Regulation	6
Comparisons of Regulatory Guidelines	7
“Say on Pay”: Communication & Managing Expectations	8
2011 Fearless Predictions: Better Times	9
2010 vs. 2009 Compensation as % of Net Revenues	10
2010 vs. 2009 Compensation as % of Pre-Tax, Pre-Comp Income	11
2010 Typical Incentive Changes (Value of Cash & Equity)	12
Incentives: Cost of Capital Can Increase Risk-Taking	13
Deferral Calculus for Banks	14
Base Salary: Tale of Two Worlds Continues	15
Sales Compensation: Pressure for Accountability	16
Investment Banking	17
Asset Management	18 - 19
Private Equity: Optimism Going Forward	20
Hedge Funds: Focus on Alignment & Ownership	21
Board of Director Role & Pay Implications	22
Summary & Final Thoughts	23

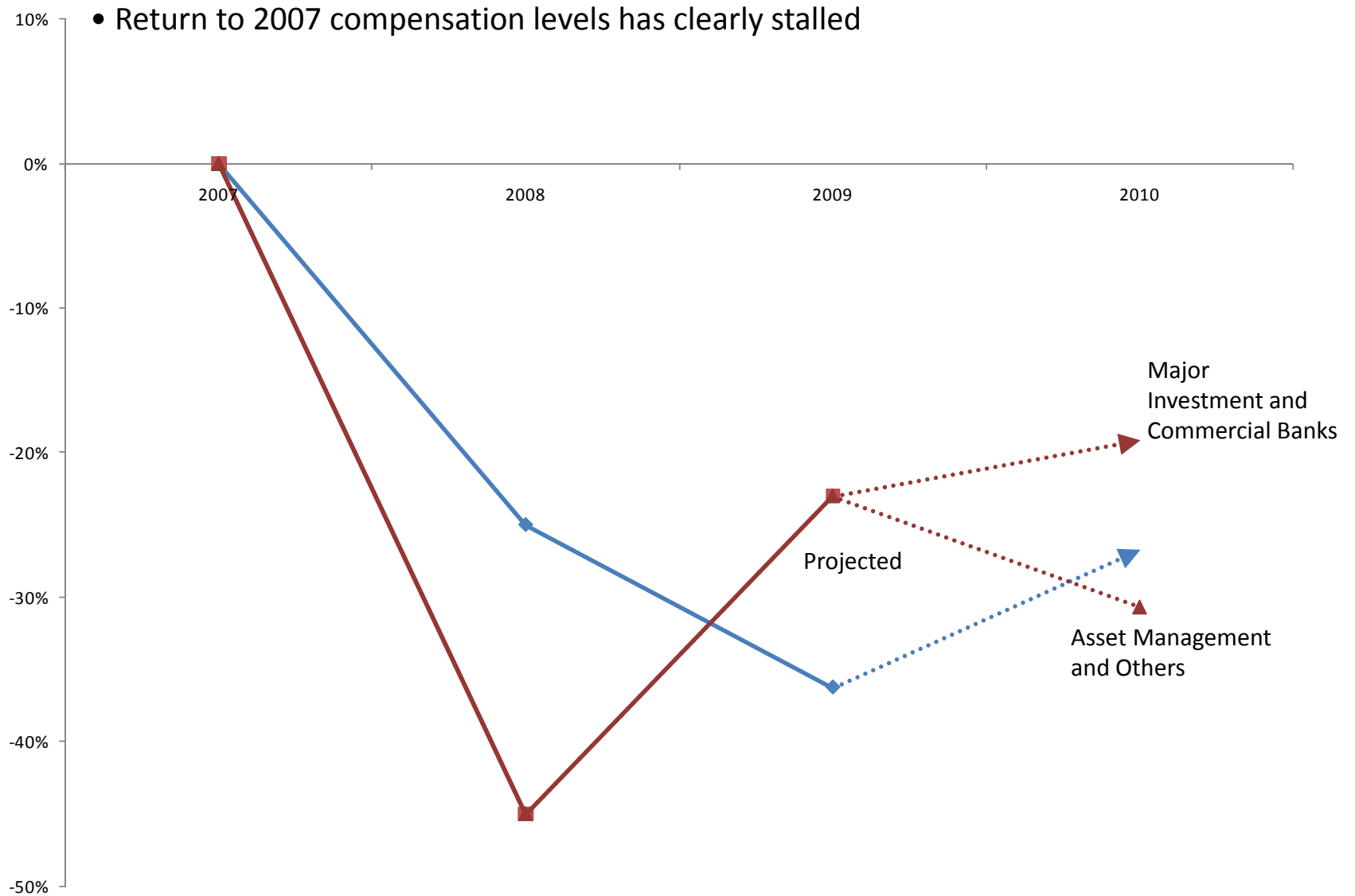
# Johnson Associates

- Long-standing, independent financial services compensation consulting firm. Pure advice, annual and long-term incentive designs, market data and levels, agreements, and goals/metrics. Equity and partnership considerations. Expertise and in-depth knowledge across comparator groups and labor markets
  - Experienced, opinionated and informed
  - Both Board consultant and company programs
- Diverse clients
  - Universal and major banks
  - Asset Management firms
  - Hedge Funds/Private Equity/Fund-of-Funds/Alternatives
  - Insurance companies
  - Brokerage firms
  - Trading organizations

## 2010 Year-End: Focus on Industry Sectors & Areas

- For 2010, significant divergence in incentive funding by sector and area
  - Major Investment and Commercial Banks (i.e., +5% to -20% or more) driven by Fixed-Income and Equities (-20% to -30%), Commercial Banking (i.e., +5%), Investment Banking (i.e., +5%), and Wealth/Asset Management (i.e., +5% to +15%). Overlay of reduced credit losses across firms
  - Market-based business up over 2009. Asset/Wealth Management (i.e., +10% to +15%), Hedge Funds (i.e., +5% to +10%) and Private Equity (i.e., +5%)
- Broader trends become clearer
  - More difficult trading environment (i.e., risk and spreads)
  - Retail and brokerage receive more focus (i.e., margins and volumes)
  - Asset/Wealth Management receive second look (i.e., margins and less capital)
  - Investment Banking remains in hold until economies recover
- Challenging to manage expectations, decipher market trends and recognize performance
  - Especially after wave of political correctness and input from various shareholder groups
- Retention concerns moderate heading into early-to-mid 2011
  - “So-so” labor market continues
- Very heavy Wall Street deferrals for 2010 and 2011
  - EU/U.K. heaviest, driving practices for European-based firms
  - Difficult dilemma for global firms wanting single program; range of market practices with Asia having less restrictions

# Mixed Incentive Trends



# Lessons from Compensation Regulation

- Most fundamental lesson: it's a political process with asymmetrical motivations
  - Different emphasis by geography will continue to evolve (Asia a “winner,” NY/London “losers”)
- Regulation includes more than significant risk-takers
  - Design emphasis down to retail brokers
- Things that will drive you crazy
  - a) Pervasive lack of knowledge; b) not caring about implications; c) weakened mainstream media
- Base salary levels are not regulated
  - High base salaries considered good/great
- Compensation deferrals resonate far more than ownership
- Assumption major mistakes can usually be linked directly to individual
- Doing more than minimum may not be rewarded
- Reliance on accounting/models to capture risk continues
- Compensation Committees have only limited patience
- Broad incentives should be funded formulaically, including cost of capital
  - Allocations subjective but should be able to be calculated

# Comparisons of Regulatory Guidelines

	<u>Dodd-Frank</u>	<u>Treasury/FED</u>	<u>FSA</u>	<u>EU</u>
Applicability	<ul style="list-style-type: none"> <li>Named executives</li> </ul>	<ul style="list-style-type: none"> <li>Sr Management &amp; those who impact/take risk</li> </ul>	<ul style="list-style-type: none"> <li>Sr Management &amp; those who impact/take risk</li> </ul>	<ul style="list-style-type: none"> <li>Sr Management, risk takers, control functions, similarly-paid employees</li> </ul>
Deferrals	<ul style="list-style-type: none"> <li>None; focus primarily on disclosure</li> </ul>	<ul style="list-style-type: none"> <li>Less prescriptive on %</li> <li>Multi-year periods</li> <li>Equity-based payments with vesting over multiple years</li> </ul>	<ul style="list-style-type: none"> <li>40% of variable deferred three years (60% above £500k)</li> <li>50% of variable in shares or subordinated debt</li> </ul>	<ul style="list-style-type: none"> <li>40% of variable deferred 3-5 years; 60% for a large bonus</li> <li>Cash limited 20%-30% of variable</li> <li>50% of bonus in contingent capital &amp; shares</li> </ul>
Clawbacks	<ul style="list-style-type: none"> <li>Current/former execs</li> <li>Restatement of financials</li> </ul>	<ul style="list-style-type: none"> <li>Return incentives if certain risk outcomes occur (<i>defined broadly</i>)</li> </ul>	<ul style="list-style-type: none"> <li>Material downturn in financials or failure in risk management</li> </ul>	<ul style="list-style-type: none"> <li>Applicable on unvested portion for poor performance</li> </ul>
Excessive Risk-Taking	<ul style="list-style-type: none"> <li>Firms must indicate relationship between executive pay and total shareholder return</li> </ul>	<ul style="list-style-type: none"> <li>Balance risk/results, without exposure to imprudent risks</li> <li>Track incentives and the corresponding risk taken</li> </ul>	<ul style="list-style-type: none"> <li>Variable pay not limit ability to strengthen capital base</li> <li>Subject to negative firm performance</li> </ul>	<ul style="list-style-type: none"> <li>Stricter capital rules on trading (3X – 4X more capital required to hold)</li> </ul>
Limits on Alternative Investments	<ul style="list-style-type: none"> <li>Cap on bank's investment in own funds to 3% of tier 1 capital</li> <li>Register with the SEC as investment adviser</li> </ul>	<ul style="list-style-type: none"> <li>Covers large banking organizations</li> </ul>	<ul style="list-style-type: none"> <li>Covers most alternative investment managers</li> </ul>	<ul style="list-style-type: none"> <li>Covers most alternative investment managers</li> </ul>
Process & Controls	<ul style="list-style-type: none"> <li>Shareholders say on pay on executive pay and golden parachutes</li> </ul>	<ul style="list-style-type: none"> <li>Risk management (audit + compliance) part of design &amp; assessment</li> </ul>	<ul style="list-style-type: none"> <li>Risk/compliance part of process &amp; compensation subject to internal review</li> </ul>	<ul style="list-style-type: none"> <li>Work closely with Risk Committee in evaluation of incentives</li> </ul>

# “Say on Pay”: Communication and Managing Expectations

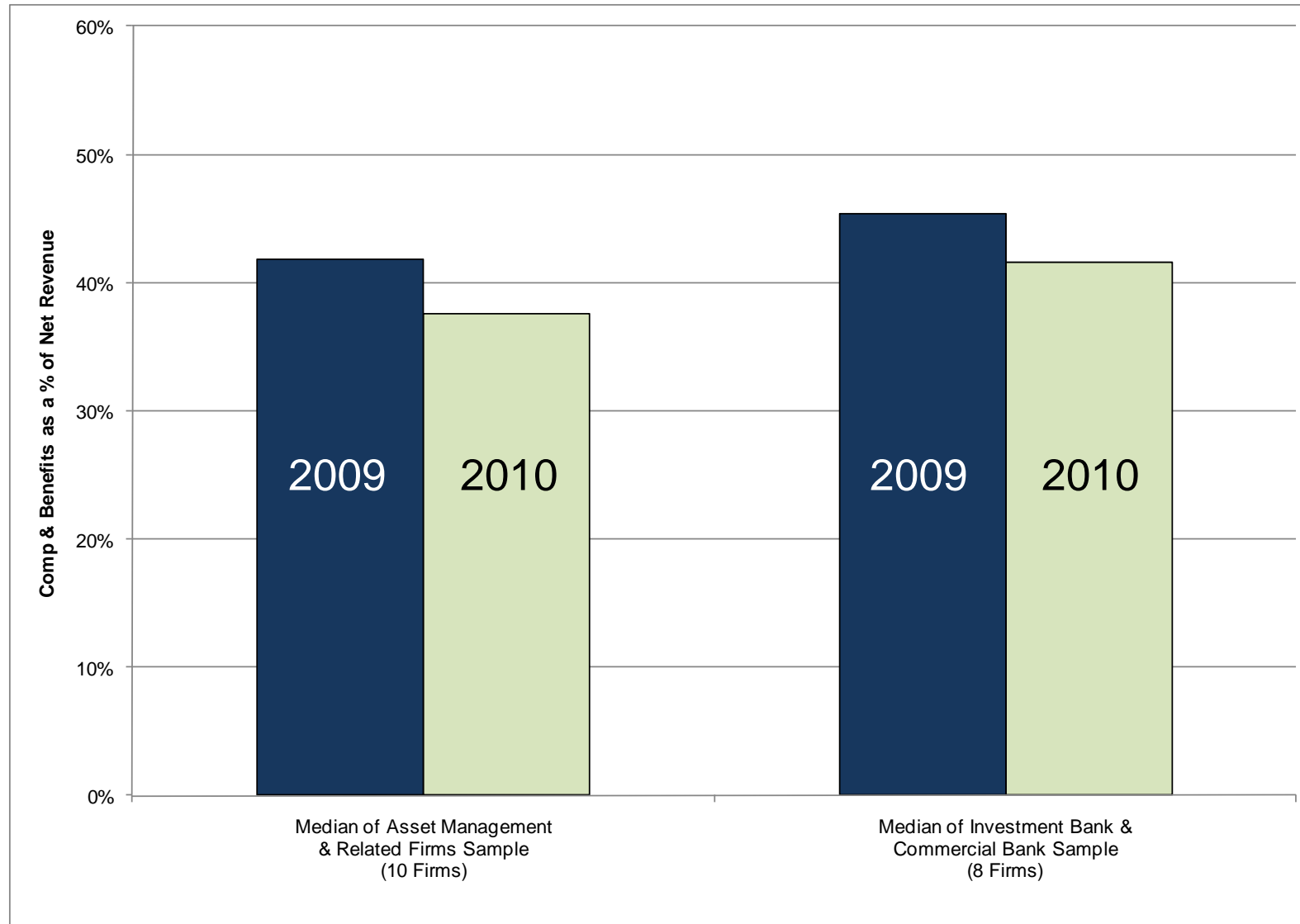
- Discourages being outside norms
  - Firms in difficulty/new management further disadvantaged
- Heightened impact of weak/nervous Directors
  - Desire to please/not stick out
  - To them, bad/no vote huge event
- Cannot satisfy everyone
  - Different guidelines and parameters
- Important to engage major shareholders
- Recognize “hot buttons”
  - Excessive contracts
  - Tax gross-ups
  - Weak clawbacks
  - Perquisites

## 2011 Fearless Predictions: Better Times

- Asset management, insurance, and alternatives stronger in 2011 (i.e. +15%)
  - Lag effect of AUM and equity valuations moves compensation
  - Still below 2007 peak
- Investment/commercial banks higher than 2010 (i.e., +15%+)
  - Fixed-Income and Equities rebound, but below 2009
  - Investment Banking and Asset Management up significantly
- Second major wave of base salary adjustments for 2012/2013
  - Regulators/politicians dislike incentives
- Regulatory/political directions further Asian expansion
  - EU/U.K./U.S. hostility drives headcount and resource changes at margin
- Intermediate prospects clouded by next major storm clearly coming
  - Inability to pay government-sponsored entitlements
  - Industry will receive blame

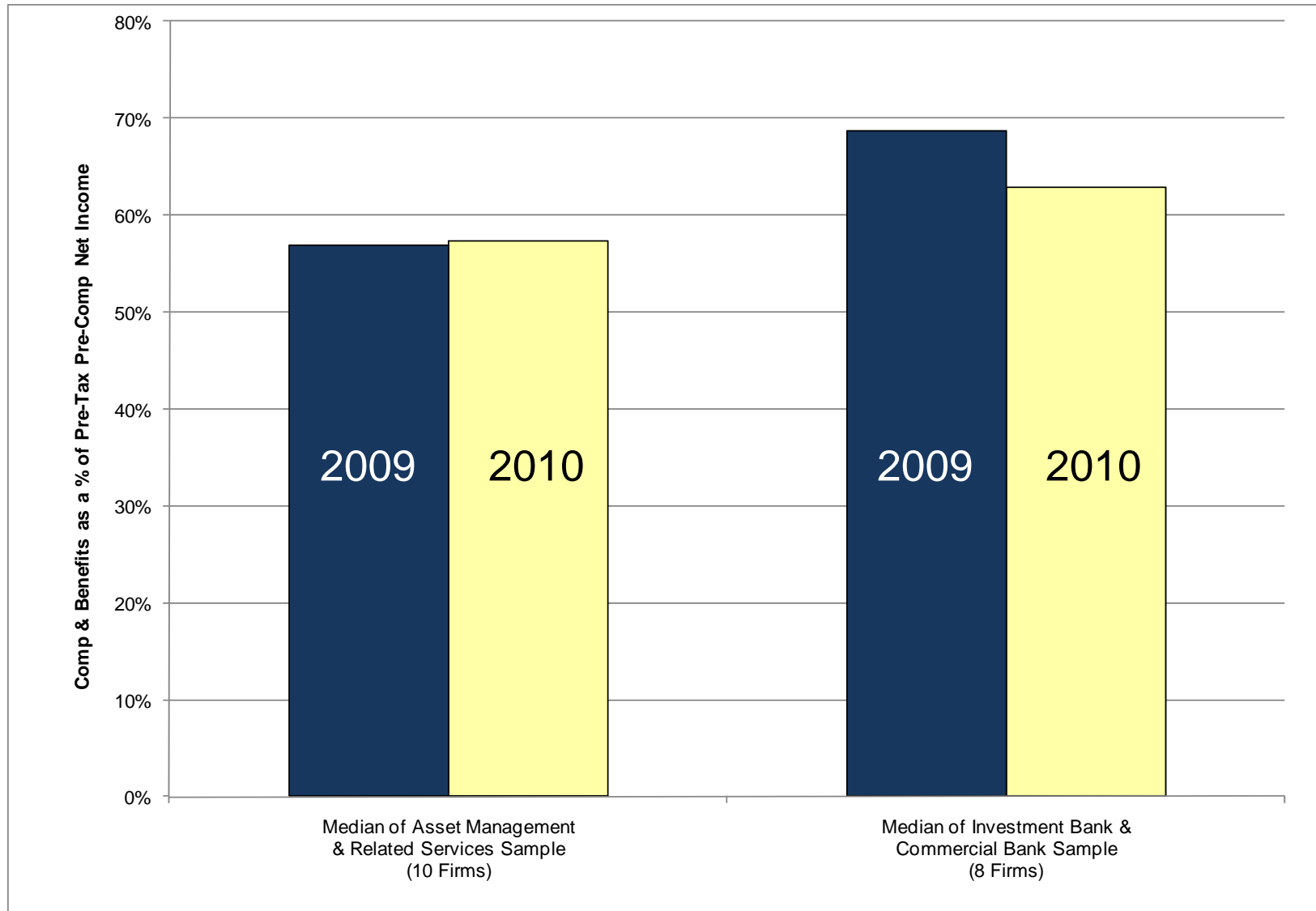
# 2010 vs. 2009 Compensation as % of Net Revenues

Note: Reflects available year-to-date data

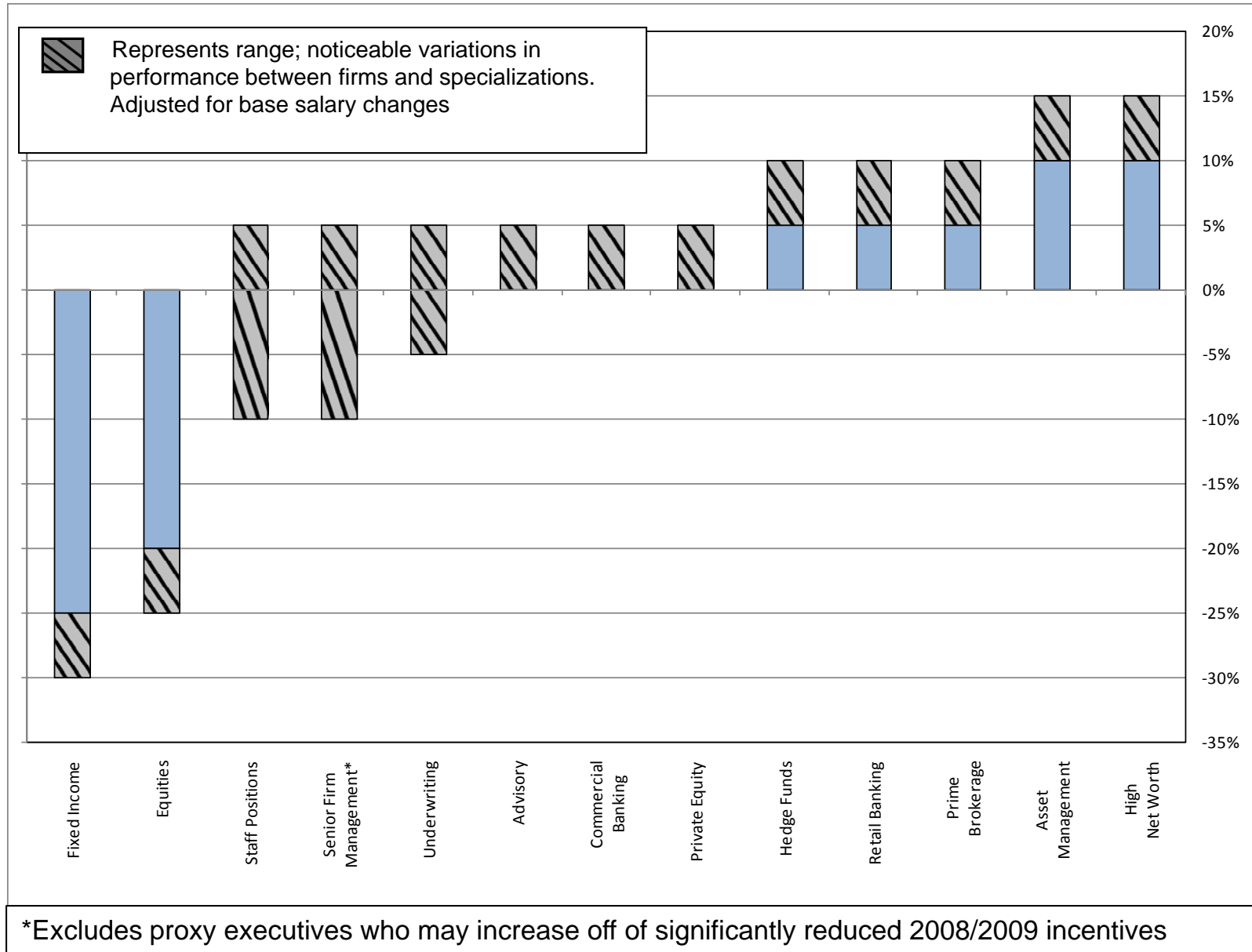


# 2010 vs. 2009 Compensation as % of Pre-Tax, Pre-Comp Income

Note: Reflects available year-to-date data

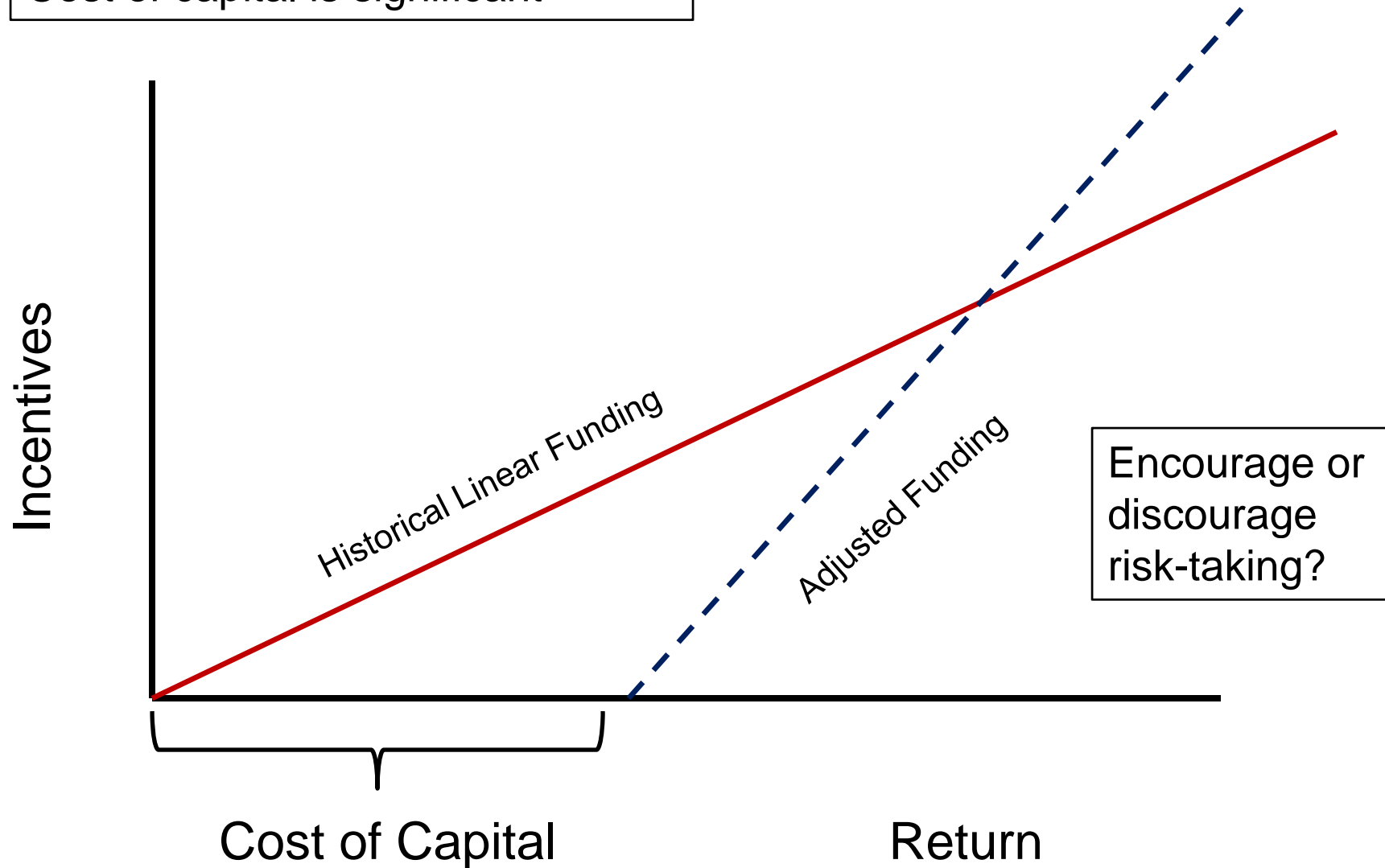


# 2010 Typical Incentive Changes (Value of Cash & Equity)

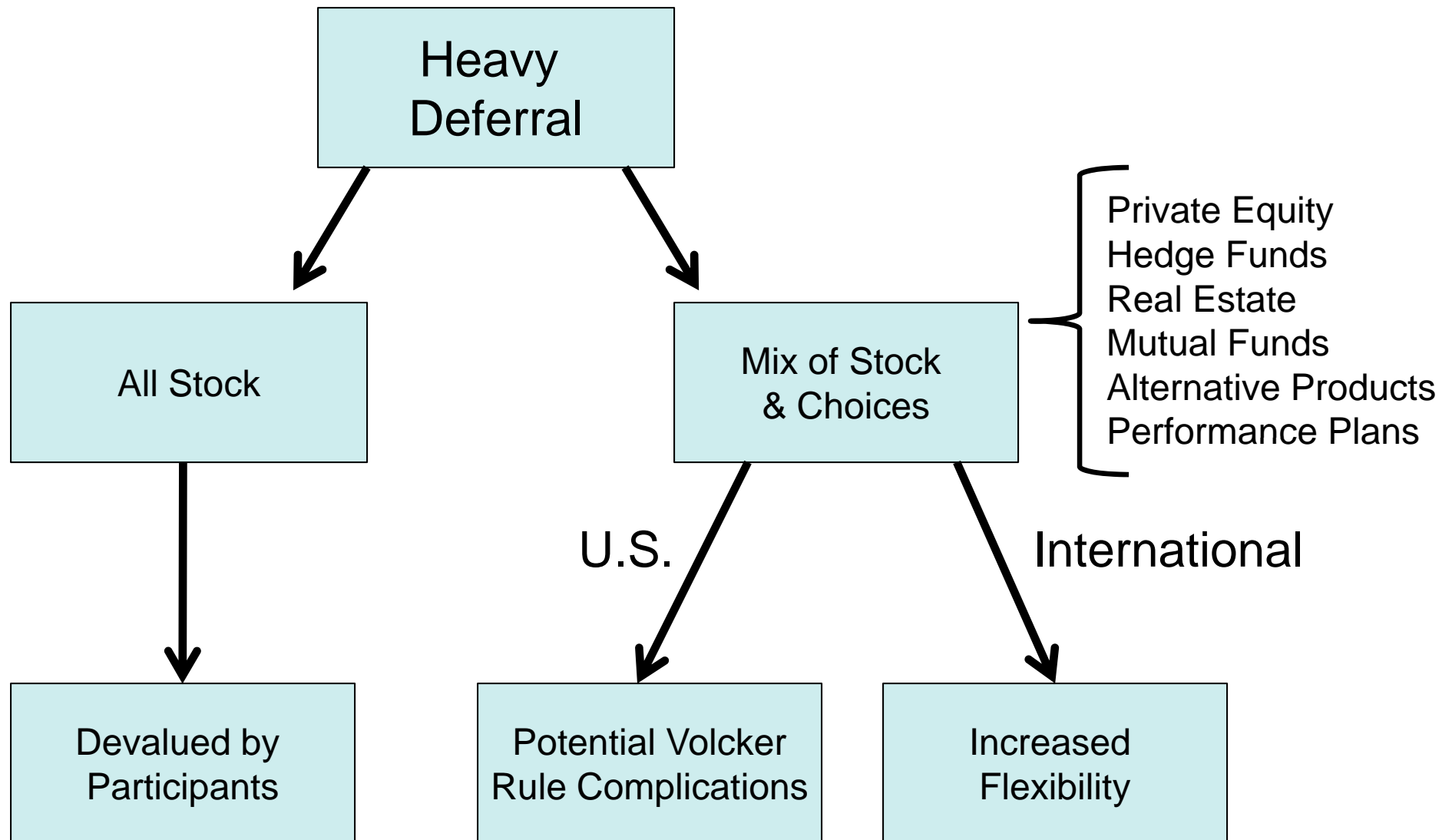


# Incentives: Cost of Capital Can Increase Risk-Taking

Difficult to actually measure risk  
Cost of capital is significant



# Deferral Calculus for Banks



## Base Salary: Tale of Two Worlds Continues

- Traditional low salary budget (i.e., 3 – 3.5%) off of usually low/moderate levels
  - Asset Management
  - Hedge Funds/Alternatives
  - Insurance

### OR

- Pay mix changed with high nominal increases (i.e., 20% - 80%), offset with incentive declines dollar-for-dollar (to date, large banks)
- Base salary levels have been too low across financial services
  - Regulators right, even if for wrong reason (i.e., meaningfully increases risk profile)
- Difficult to maintain with movement between “two worlds”
  - Bias towards higher salaries over time

# Sales Compensation: Pressure for Accountability

- Emphasis on sales compensation across businesses continues
  - Consistent resources across longer sales cycles
  - Retention key with improving market
- Recognize potential misalignment between sales funding and overall firm
  - Higher objective compensation, less socialistic
  - Little firm impact
  - Cost of doing business
- Pressure for nuanced results
  - Appropriate products
  - Client retention
  - Team efforts
  - New clients
  - Multiple products by client
- Performance differentiation increasingly important
  - Real movements towards shifting grids/payouts from bottom to top

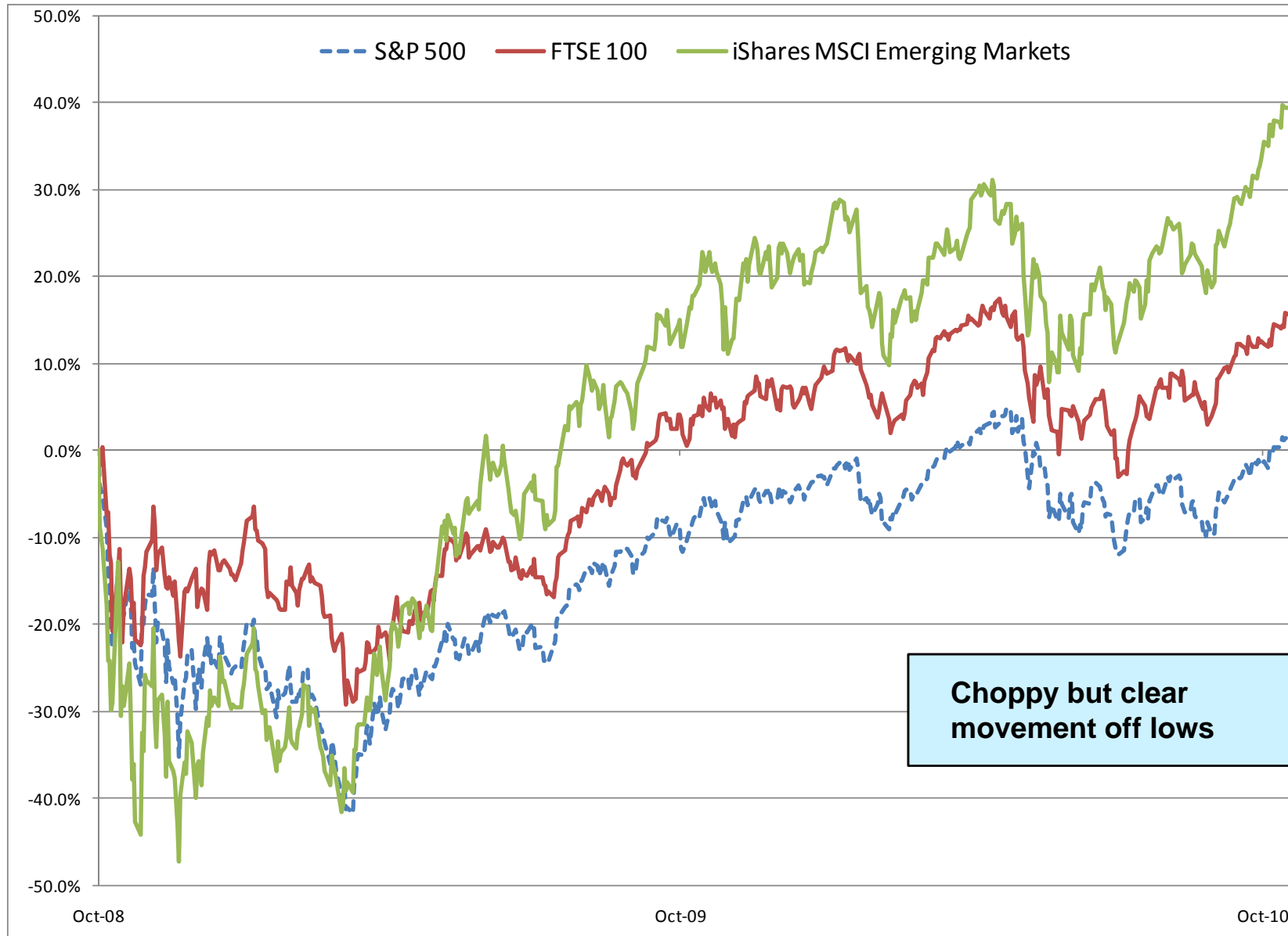
# Investment Banking

- 2010 compensation for senior professionals stable
  - Strong trading revenues supported 2009; offset for better 2010
- No obvious big uptick until economic growth
  - Otherwise slow improvements in advisory and underwriting
- Equilibrium in research
  - Buy-side research provides enhanced careers and higher compensation
  - Competition from hedge funds has moderated
  - Premium for quantitative analysts disappeared; fundamental in vogue
- Otherwise, becomes more central as less capital devoted to trading
  - However, will also impact compensation ratios

# Asset Management

- Asset management stabilizing with market rebound
  - Improving investor sentiment leading shift back to equity products
  - Market rebound creates inflated compensation expectations
  - Difficult business to understand for many parent companies
- Positive trending market conditions having similar impact on wealth management
  - Increasingly competitive environment, given focus on less capital-intensive businesses
- Partner pay model common
  - Pre-agreed % of operating profit available for incentives
- Sales
  - “Commission” plans with weighting on new assets/retention
- Investment professionals
  - Generally objective and leveraged program on 1-, 3-, 5-year benchmarks
  - $\cong$  20% for broader contributions (i.e., involvement in selling of funds, management, product development, etc.)
- Also better in 2011, due to lag effect of AUM

# Asset Management



# Private Equity: Optimism Going Forward

- Difficulties moderate
  - Poor investments more in past
  - 2009 and 2010 vintages look promising
- Still a longer-term business focused on carry; structural trends:
  - Proportionately more to top professionals; 3 top/key people
  - Longer vesting
  - Improved terms for firm protection: clawbacks/non-competes
  - At captives, often 10-13 pts in aggregate due to firm economics and sales support
- Scale a major pay consideration
  - Allowing the largest firms to outspend for talent

- **Optimism from market upturn. Consensus that opportunities exist, particularly in emerging markets and Asia**

# Hedge Funds: Focus on Alignment and Ownership

- Better 2010 as more above high-water marks
  - Industry has stabilized
  - Fund owners paid in 2009 to ensure stability
- Increasing need for alignment and broader ownership
  - Views of investors and consultants
- With oversight and regulations, incentive design details receive more focus
  - Risk profile
  - Alignment to both portfolio and firm
- Quick Equity Design Checklist
  - Pricing and Valuation
  - Amount
  - Participation
  - Permanent/Expires
  - Vesting
  - Non-Competes
  - Change-in-Control/Severance
  - Transition/Multigenerational

# Board of Director Role and Pay Implications

- Increased time commitments, complexity of issues and new legislation/regulation more evident now than ever
  - Pressure for increased accountability
  - Unprecedented scrutiny of pay designs and magnitudes
- “Say on Pay” increases pressure
  - Will highlight impact of weak/nervous Directors
- Transparency and proactive communication between Boards and management
  - Crucial importance of open communication
  - Boards retain discretion on payouts
- While requirements increased, compensation growth slowed
  - Consistent with declines for management and employees
- Meaningful compensation plan
  - Major Committee heads not paid enough vis-à-vis other directors
  - Need more expertise on Compensation Committee (i.e., Human Resources)

# Summary and Final Thoughts

- Financial services landscape stabilizing
  - Recovery outpacing overall general economy
- Compensation results will be mixed and confusing for 2010
  - Differ by business: Wall Street vs. Asset Management and Alternatives
- Heavy deferrals continue and amplify
  - High rates for multiple years in a row no longer an emerging trend
  - Must be more creative; professionals do not always want stock
- Most continue to be disappointed competitive pay paradigm has not changed
  - “If you produce, you will be paid” ...pay delivery/elements may differ
  - Risk and capital charges difficult to formulaically build into programs
- Financial Services pay will continue to be under unprecedented scrutiny
  - Risk still not well defined; unclear laws and regulations
  - Regulatory, political, and investor pressures ongoing
- 2011 will continue the rebuilding of the industry
  - Much to be proud of in 2009 - 2010