

2014 Financial Services Compensation:

Moving Beyond Banks in Financial Services Pay

PRESENTATION AND DISCUSSION

November 10, 2014

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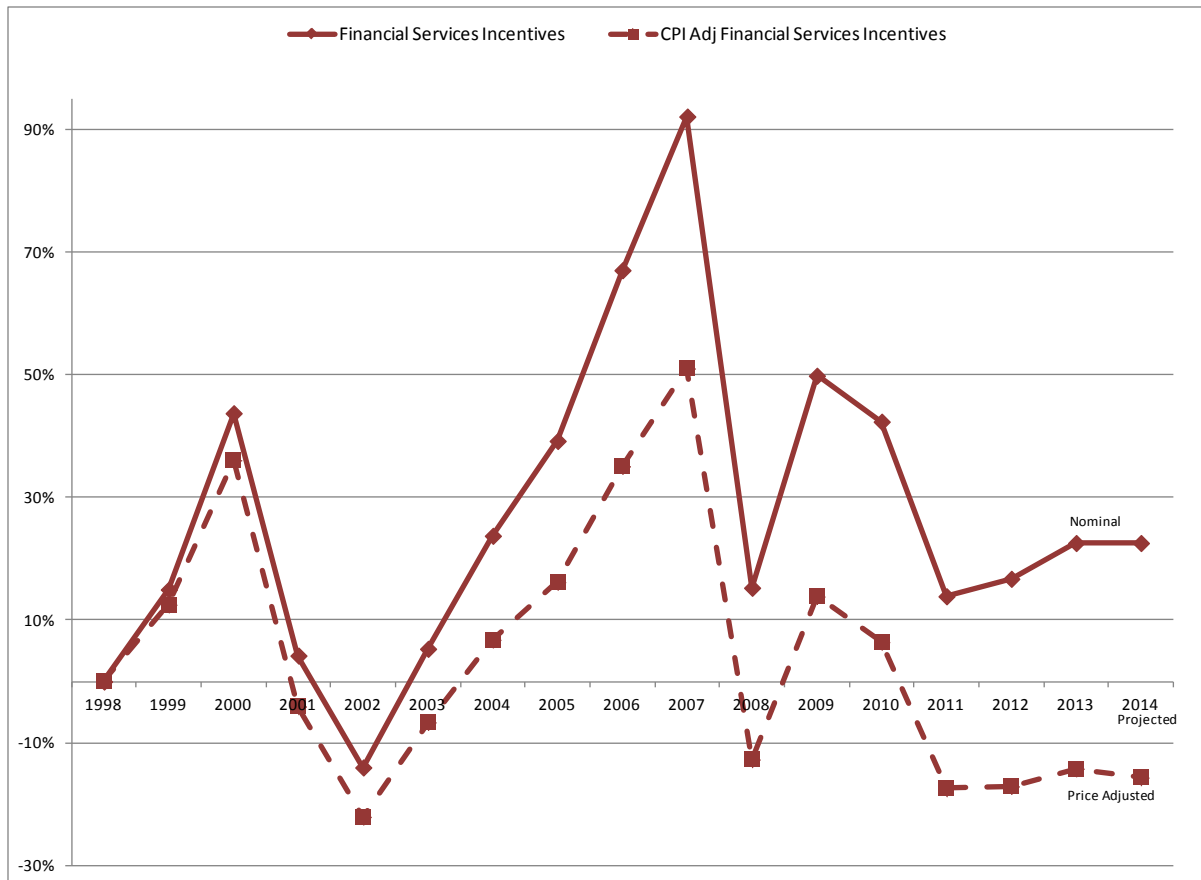
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- Independent financial services compensation consulting firm providing informed advice and counsel, with customized solutions grounded in best practices. Expertise navigating global regulatory and political headwinds to develop compliant yet aligned programs. Common services include annual and long-term incentive designs, market data, agreements, equity and partnership considerations, and Board Committee advice
 - Balance market/best practice with firm dynamics
 - Both Board consultant and company programs
 - Experienced, opinionated and informed

- Diverse clients and issues
 - Universal and major banks
 - Asset Management and Wealth Management firms
 - Hedge Funds/Private Equity/Fund-of-Funds/Alternatives
 - Insurance companies
 - Brokerage firms
 - Trading organizations

What Has Really Happened to Banking Compensation?

- 2005-2008 was an unprecedented compensation bubble
 - Followed by both an economic and political disaster
- 2014 continues to lag long-term trend on compensation and financial performance
 - Exits from industry (i.e. strategies, businesses, and individuals)
- Historical and recent analysis suggests expected 15%-25% premium to work on wall street



Banking Compensation Going Forward

- Compensation will trend towards a 20% improvement from today
 - Pay equilibrium compared to other career choices
- Upside limited by (a) capital requirements, and (b) broadly defined regulatory costs, business mix, and more efficient markets
- Downside limited by reliance on retail and wealth/asset management and less trading focus
- Over intermediate term European banks hindered by home market regulation and political constraints/demands
- Alternatives and asset management surpasses banking as perceived pay leader. Banking has had late start on building positive cultures and careers

Three Hard Earned Lessons From the Financial Crisis

- Easy to undervalue excellent performance
 - Rule of thumb: excellent performers produce 2x or more average contributions
 - Significant pay differentiation critical
- Overly fearful of even moderate voluntary turnover
 - Average voluntary turnover quite low/too low
- Not enough emphasis on culture/training/promotion from within
 - Positive culture matters; reduces needed compensation spend
 - Recognizing trend toward improving work life balance

2014 Year-End: Importance of Client Businesses

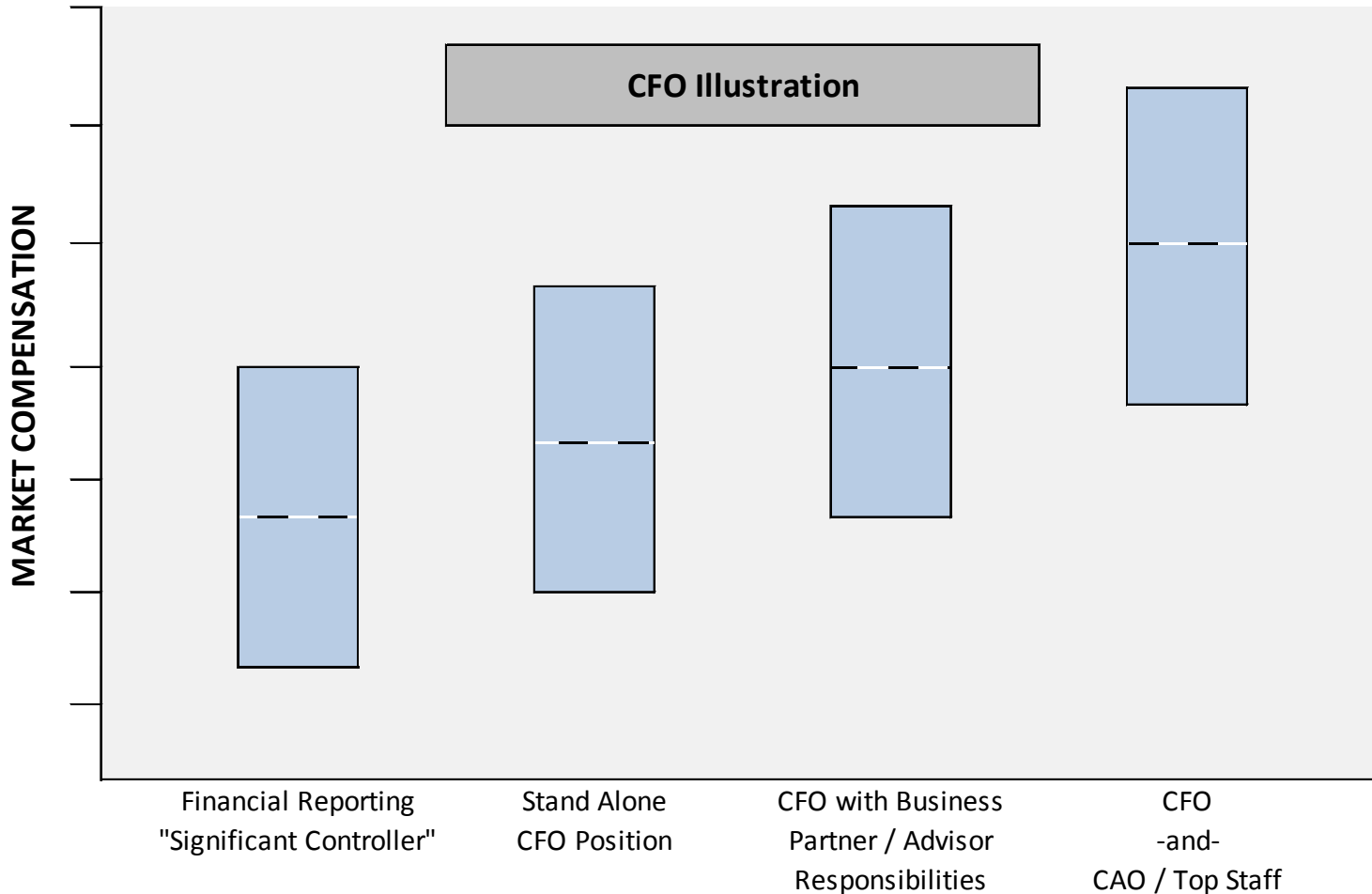
- U.S. Major Banks' incentives generally flat (i.e. -5% to 5%) with European banks down moderately (i.e. down 5% to 10%)
 - Fixed income : -10% to 0%
 - Equities: -10% to 0%
 - Investment Banking: Advisory +10% to +15%, Underwriting +5% to +15%
- Client business up on better fundamentals and AUM increases
 - Asset Management: +5% to +10%
 - Wealth Management: +5% to +10%
 - Private Equity: +10% to +15%
 - Hedge Funds: -10% to +5%
- Regional firms often outperforming major banks
 - Better local markets and fewer legacy issues
- As expected, European pay allowances under scrutiny
 - Will require higher base salaries and some risks
- Viable equity increasingly important for improved alignment and motivation
- Major Banks not compensation leaders: Market driven by asset management and alternatives

Capital by Thomas Piketty: Pay Related Insights

- Book provides careful analysis of individual income inequality over the past 200 years
 - Data is strong even if policy directions are debatable
- Developed countries \cong 1% annual growth in real income
 - Suggests competitive business markets going forward
 - Highlights importance of having excellent talent and aggressive approach
- Inequality of income/wealth has risen significantly
 - Financial services compensation will continue to face scrutiny
 - Continues to be larger issue in Europe than U.S.
- Income and wealth have always been important political considerations

Key Senior Staff Compensation

- Key senior staff market compensation information often reflects positions with significantly different responsibilities and impact. Have often found multiple (i.e. four) levels for common staff roles. Clarity on level helps both in compensation positioning, but also in applying market data



Difficulties with Structured Compensation

Need to understand strengths/weaknesses of structured compensation

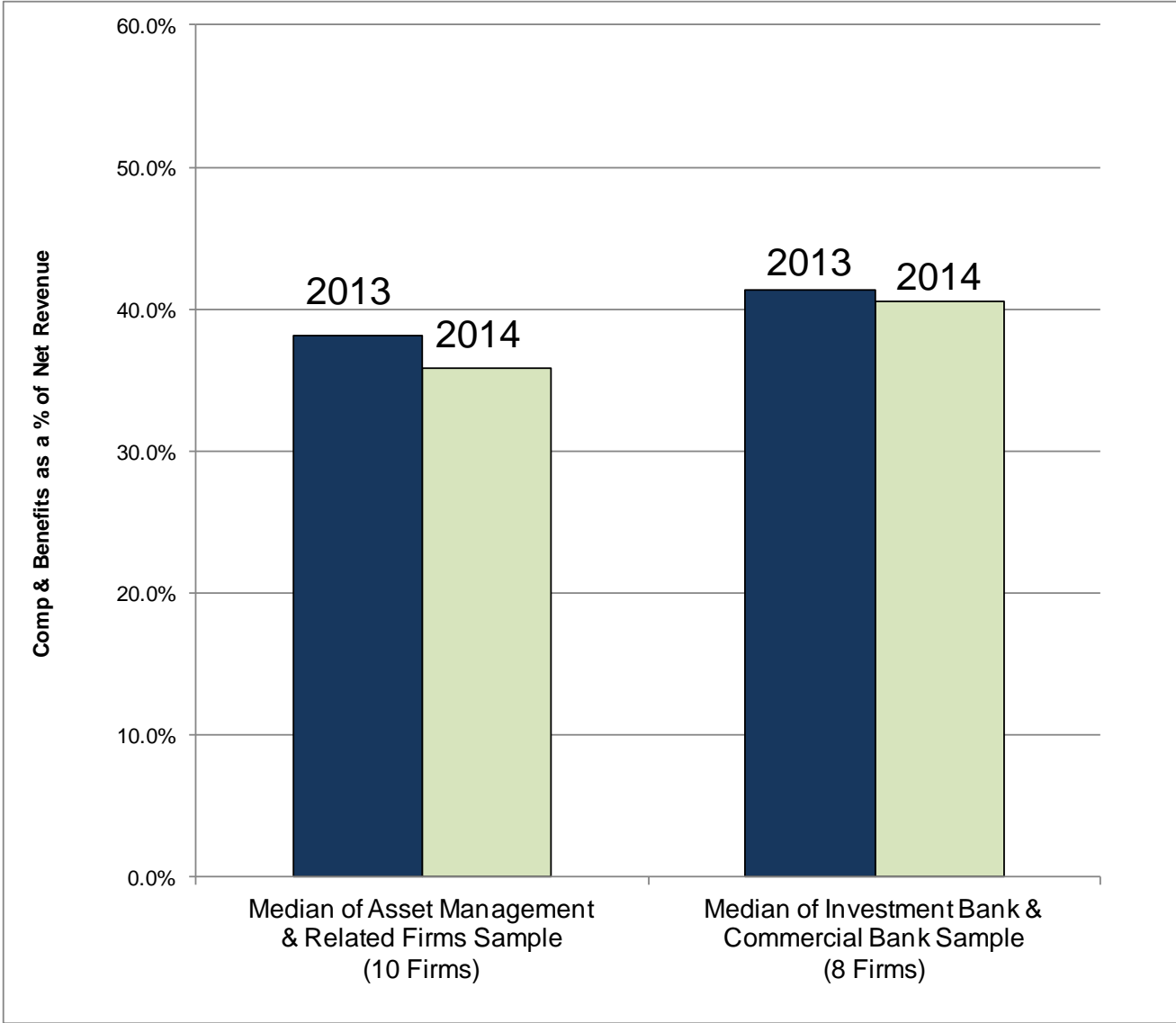
- Base salary structures assume ability to move through each grade in reasonable period
 - Enter at 80% of midpoint market, and move to 100%-120% over time
 - With 3% salary budgets math does not work (i.e. 10 years to reach market)
 - Often sensible to start closer to market and then rely on incentives and promotions
- With changing markets, incentive targets become dated (high or low)
 - Need guidelines and ranges, not purely quantitative calculations
 - Review targets on bi-annual basis
- Earning performance-based long-term awards on future results problematic
 - With accounting adjustments, goals become clouded
 - Relative performance only as good as peer groups
 - Targets not adjusted for economy or interest rates

2015 Fearless Predictions: Equilibrium

- Asset/Wealth Management and Alternatives continue momentum (i.e. +10% or more)
 - Continued strong AUM levels
 - Focused expense management
 - Fee pressures but medium term issue
- Investment/Commercial Banks move with economic conditions (i.e. +5%)
 - Both fixed income and equities improve moderately on less capital
 - Asset/Wealth Management improve but limited internal traction
 - Expensive infrastructure and legacy costs
- Paradigm shift continues towards non-bank compensation and careers
 - Perceived as better cultures and alignment
 - Tailored equity plans
- Continued advantages in being away from New York/London/EU
 - Costs and hostile governments
- Need for fundamental changes in cost structures
 - Banks and some asset managers need to reassess infrastructure and business lines

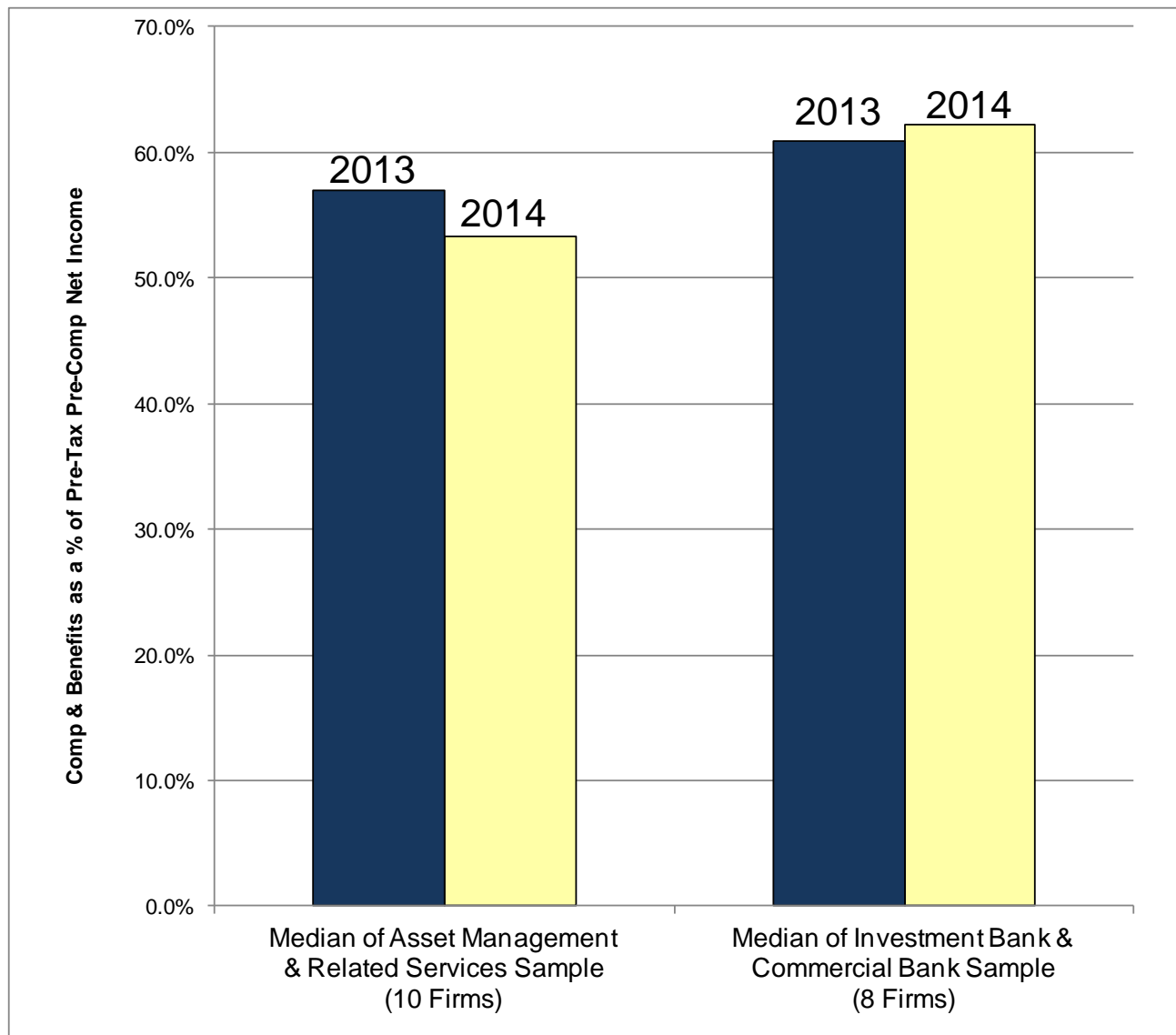
2014 vs. 2013 Compensation as % of Net Revenues

Note: Reflects available year-to-date data

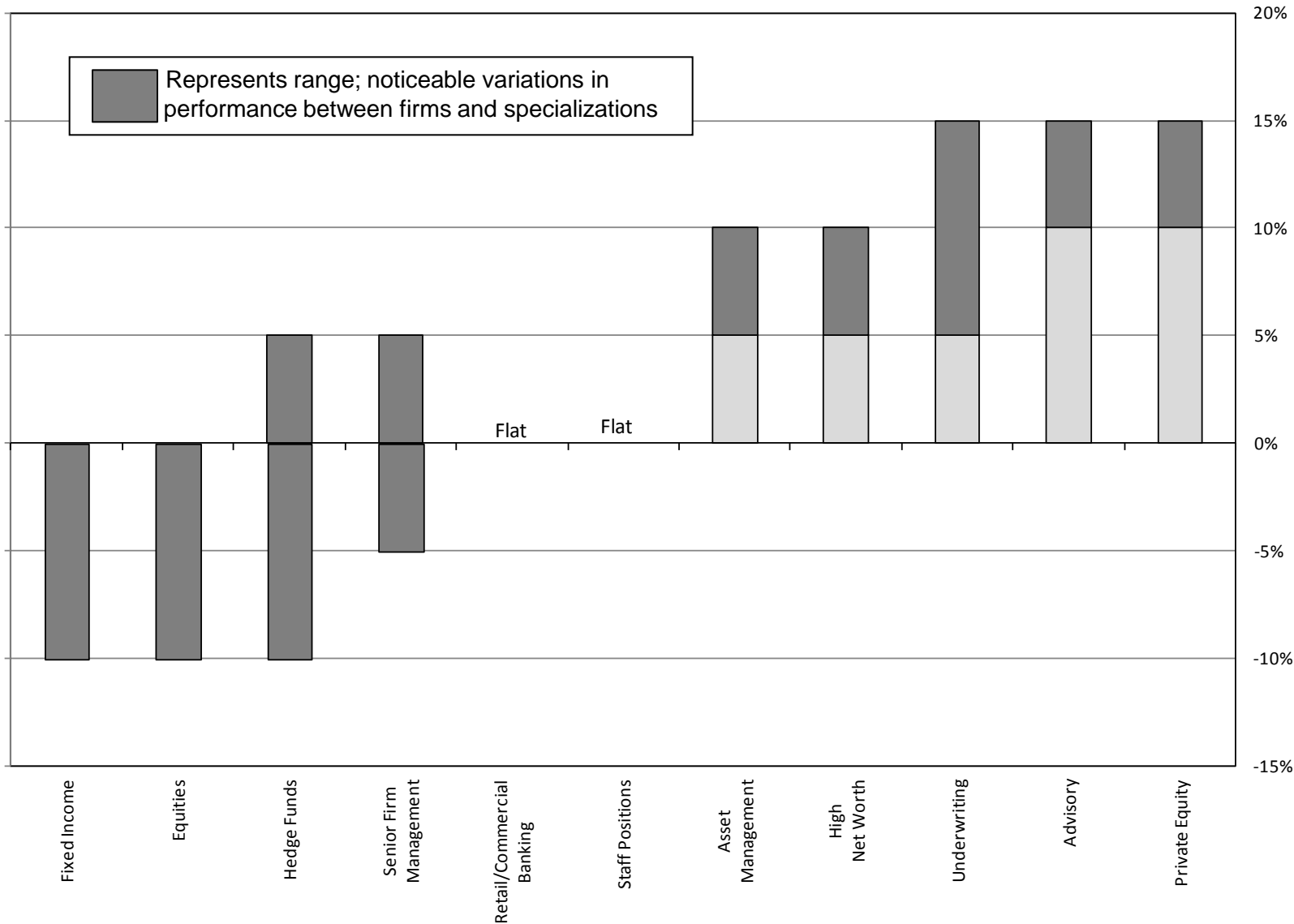


2014 vs. 2013 Compensation as % of Pre-Tax, Pre-Comp Income

Note: Reflects available year-to-date data



2014 Typical Incentive Changes (Value of Cash & Long-Term / Equity)



*Excludes proxy executives impacted by firm specific circumstances

Trading: Broadly-Evolving Talent Requirements

- High-end technology and software skills in demand
 - Google, Apple, and Facebook are competitors for talent
- Entry level compensation can be quite skewed- 90th, 95th or higher percentiles
 - Requires current market data for particular skills and talents
- Base salary of greater importance
- Recognize higher level of voluntary/involuntary turnover
 - High bar for success
 - Meaningful other opportunities
- Lean headcount optimal/required
 - Makes high-end compensation affordable
 - Drives line-of-sight accountability

Banks: Overdue Straightforward Career Steps

- Promote from within
 - Hard to have a long career perspective if 50%+ of positions filled externally
 - Goal of 75% internal promotions
- Terminate those who fundamentally don't share values
 - Cost of tolerating “Bad Actors” high and going higher across multiple dimensions
- Increase training on relevant skills
- Instill sense of being part of something
 - Alternative is being generic firm with little emotional attachment
 - Helps drive offering clients can relate with
 - Many firms have lost what makes them special

Asset & Wealth Management: Key Pay Issues


- Firm equity for alignment
 - Surprising importance both for independents and captives
 - Impact of clients and investment consultants
- Incentive funding on results vs. survey “bottom up” approach
 - Many/most successful firms fund on results. Impacts aggressiveness, headcount, and expense control
- Significant focus on sales compensation design
 - Commission vs. hybrid vs. subjective
 - Reflects involved sales process and multitude of products/channels
- Meaningful year-over-year compensation changes for high performers
 - Focus on portfolio management
- Deferrals remain moderate and equity issues surrounding succession



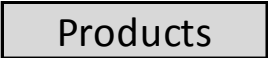
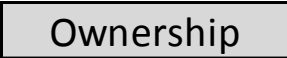

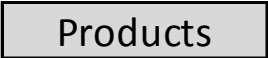


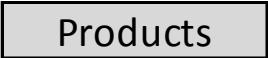


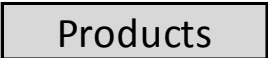



Senior Bank Executive Compensation

- Bank executive incentives broadly flat (i.e. -5% to +5%)
 - Firm by firm variations
 - Senior management moves with other professionals and firm's results
- Overall compensation is roughly consistent with performance
 - “So-so” results with “so-so” pay. Better link than in 2010-2013
 - Current pay bands for bank executives below high-end asset management (also weaker performance)
- Unclear if capital intensive organizations scaled correctly
 - Need to reexamine business models in low return environment
- Long-term incentive grants/earnouts on annual awards complicate comparisons
 - Structure and goal difficulty varies by firm
 - Continual accounting charges reduce motivational impact
- In banks little innovation beyond basic structures
 - Significant ownership guidelines
 - Risk sharing bonds endorsed by regulators
 - Stock options and other growth instruments

Deferral Choices and Alternatives

- Variety of deferral choices utilized depending on business

 Shaded box "often utilized" vehicle

<u>Business</u>	Range of Potential Vehicles			
Bank	 Stock	Products	Options	Bonds
Captive Unit	 Stock	 Products	 Ownership	
Asset Management	 Stock	 Products	 Options	
Private Equity	 Stock	 Products	 Carry	
Hedge Fund	 Stock	 Products	 Incentive Fees	
Insurance	 Stock		 Options	

Private Equity: Affordable Annual Compensation and Carry

- Positive recent vintages but highly competitive
 - Need both financial and operating skills
- Reduction in fees moderate available annual compensation
 - Greatest impact on mid-sized firms. Significant headcount/costs without full scale economics of larger firms
 - Need compensation process and market data. Informal process and folklore less effective
- Headcount needs to be managed more carefully
 - Leaner boutique models. Competitive advantage and efficiency
 - Fewer professionals who are paid well, challenged, have career opportunities, and are accountable
- Consider less annual compensation for founders and senior partners
 - Historical %'s may need to change to reflect fee streams
- More effective use of carry to recognize performance
 - Larger reserves for future awards (i.e. 30% and forfeitures)
 - Back-end vesting (i.e. pro-rata on 80% over 5 years; 20% on realization)
 - Deal-by-deal carry for operating partners (i.e. 1 point)

Hedge Funds: Compensation Model Variations

- Base salary levels continue to be moderate
 - Competitive levels important for staff
- Annual investment team bonus
 - Solely from pre-determined incentive fee
 - or
 - Combination of discretion/formula
- Need for cooperation
 - Overlapping strategies or broader firm impact suggest blend of portfolio and firm results
- Firm equity continues to be key element
 - Valuation often a stumbling block
 - Use of profit units can balance current value and future growth
- Deferral vesting terms focus on competition
 - Increasing non-compete/non-solicit
 - Focus on retention and stability

Important Choices In Addition to Gardening Leave

- Firms continue to consider appropriate protections. Requires business-by-business and geographic awareness
 - Address early in business evolution

<u>Provision</u>	<u>Intended Purpose</u>	<u>Comments</u>
Gardening leave	Short period to stop immediate solicitation of clients	Expensive and common feature often overused
Non-compete (\$)	Penalize leavers (short term focus)	Nearly universal practice
Non-compete (stop employment)	Legal action for competition	Use increase but still selective. 6-12 months common
Non-solicit of clients	Protect clients	6-12 months common
Non-solicit of employees	Protect firm	1 year quite common
“ Clawback”	Return and forfeit awards for bad behavior	Often untested broad language

Compensation Committee Beyond Simple Governance

- Compensation Committee with simple governance focus
 - Senior executive levels and addressing ISS/Glass Lewis mandates
 - Less proactive in terms of business impact
- Real governance should be broad rather than narrow concept
 - Compensation philosophy
 - Performance metrics, goals, and measures
 - Equity strategy
 - Ownership
 - Incentive funding and affordability
 - Business unit variations
 - Working knowledge of key incentive programs
 - Understanding of turnover and diversity
- Compensation committee should reconsider mission
 - Move beyond minimal compliance, and consider activities with greater impact
 - Surprising few major companies have Human Resource backgrounds on Committee

Summary and Final Thoughts

- Bank compensation has reached short-term equilibrium
 - Move with economy
 - 20% below long-term trend line
 - Must continue to adjust cost structure
- Asset management and alternatives compensation leaders
 - Economic and cultural advantages
 - Compensation process/funding and use of market data
- Human Resources initiatives needed
 - Refocus on excellent performance
 - Culture matters
 - Train and promote from within
 - Lean staffing and adequate turnover
- Sales compensation evolving
 - Hybrid approach reflects complexity of sales process, products, and channels
- Firms must continue to reduce costs and complexity. More aggressive management of human resources
 - Compensation will trend upwards with the economy