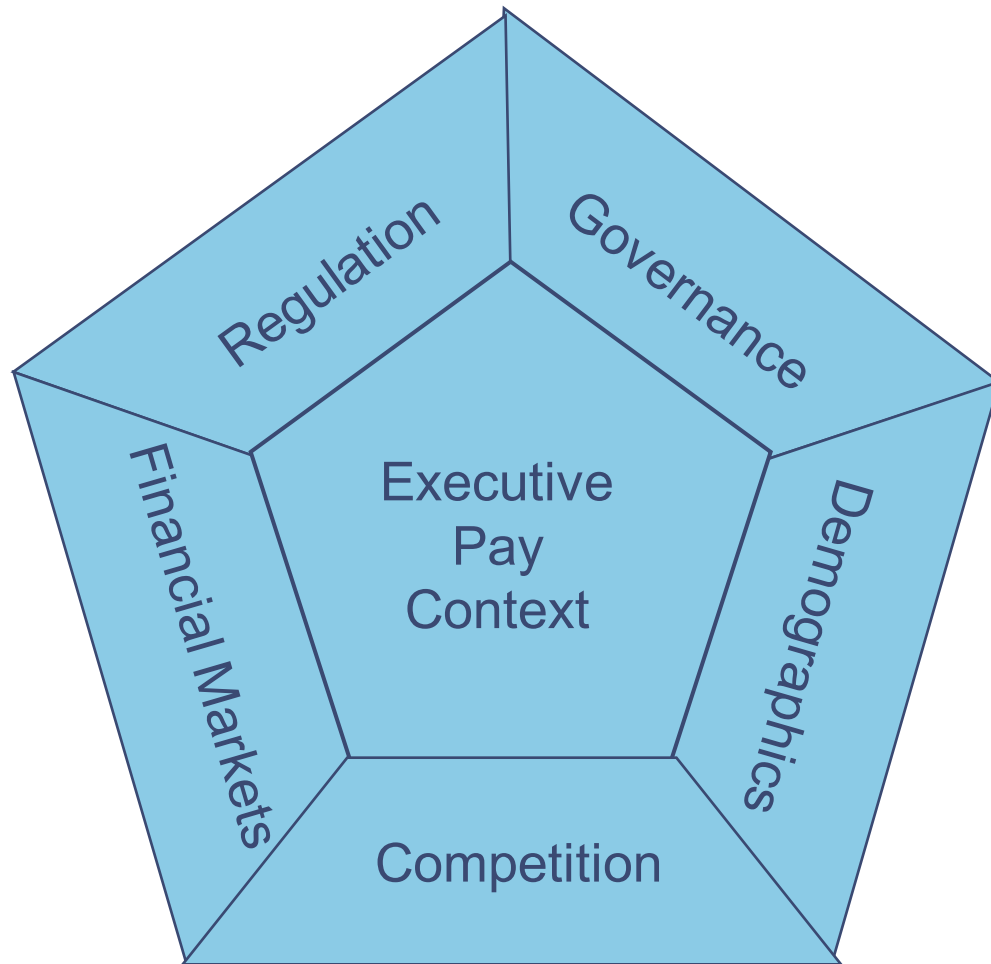


SARA Conference, 6th & 7th November 2008

The Journey in Executive Remuneration Yesterday, Today, Tomorrow



An extraordinary decade for executive pay



Three mega-trends

1.	Governance & Regulation	Guidelines, Disclosure, & Say on Pay	What has it achieved?
2.	Pay for performance	The Incentive Paradigm	Has it worked?
3.	The Executive Pay Explosion	Superstar Executives	Is the party over?

Three mega-trends

1.

Governance &
Regulation

Guidelines,
Disclosure, &
Say on Pay

What has it
achieved?

Governance and disclosure

Increasing convergence around three key planks of governance



Best practice guidelines



Disclosure



Say on Pay

Governance and disclosure

Successes

- Termination payments
- Golden parachutes
- Performance conditions

Failures

- Pay ratcheting
- Pay-performance alignment
- Motivation of executives

Governance and disclosure

Successes

- Termination payments
- Golden parachutes
- Performance conditions

Failures

- Pay ratcheting
- Pay-performance alignment
- Motivation of executives

...and it didn't stop the credit crunch (see later)...

Three mega-trends

2.

Pay for
performance

The Incentive
Paradigm

Has it worked?

Three questions

Q1: How many of you consider your annual bonus plan to be highly valued by executives and a driver of behaviour?

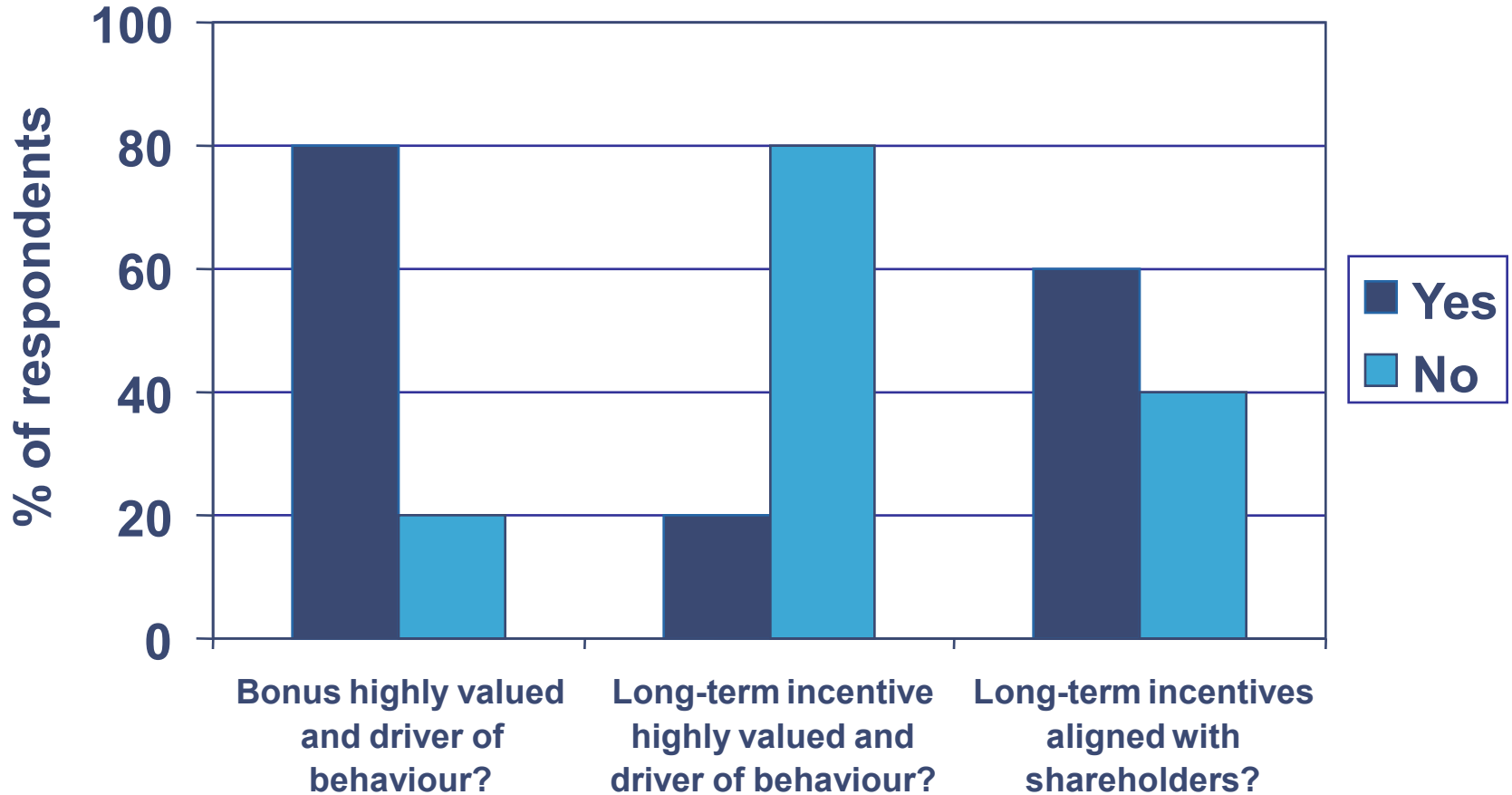
Three questions

Q2: How many of you consider your long-term incentive plan to be highly valued by executives and a driver of behaviour?

Three questions

Q3: Do you think that your long-term incentives are well aligned with shareholder outcomes?

Three questions



Source: very unscientific informal client survey

Weak relationship between reward and performance

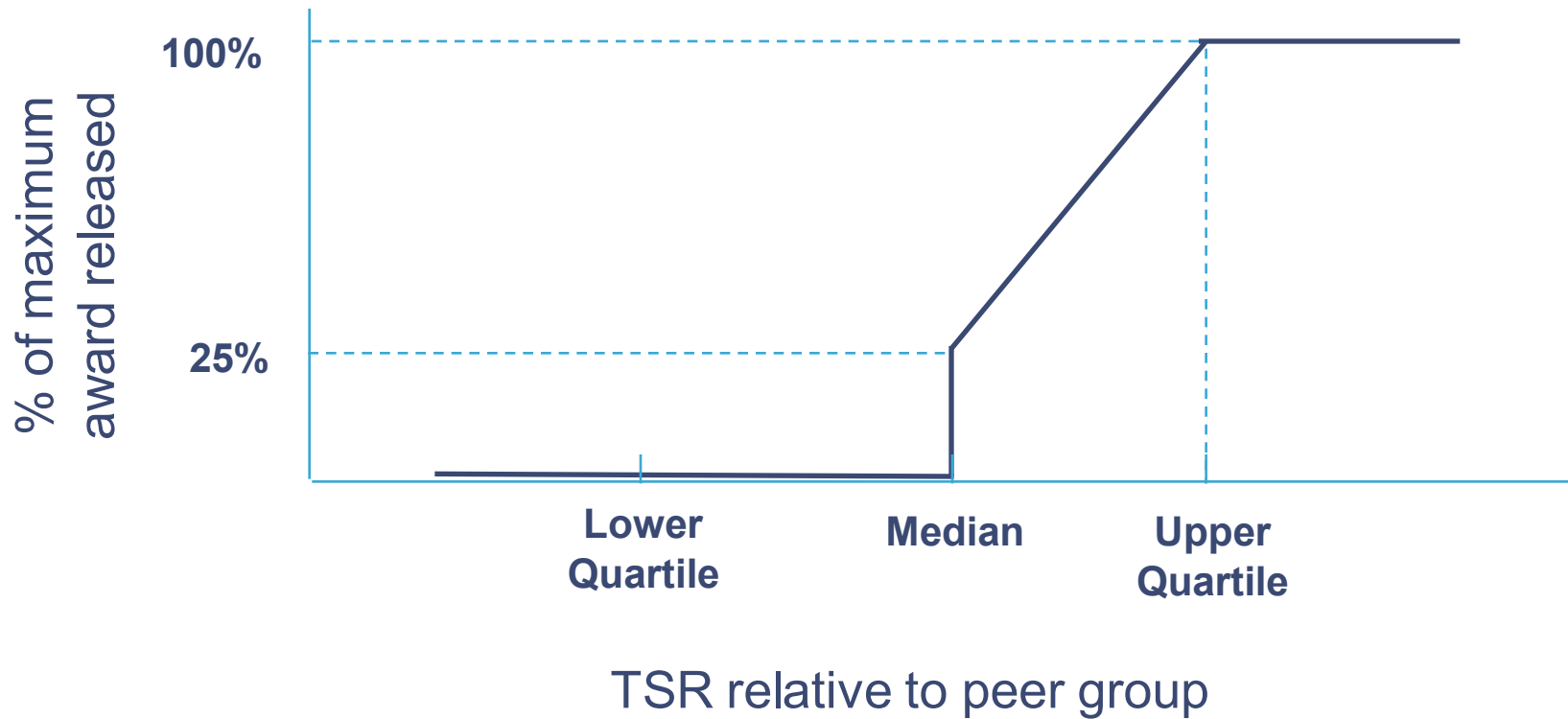
Incentives Versus Performance
FTSE-100: 2001 to 2006



Source: IDS, Datastream, PwC Analysis

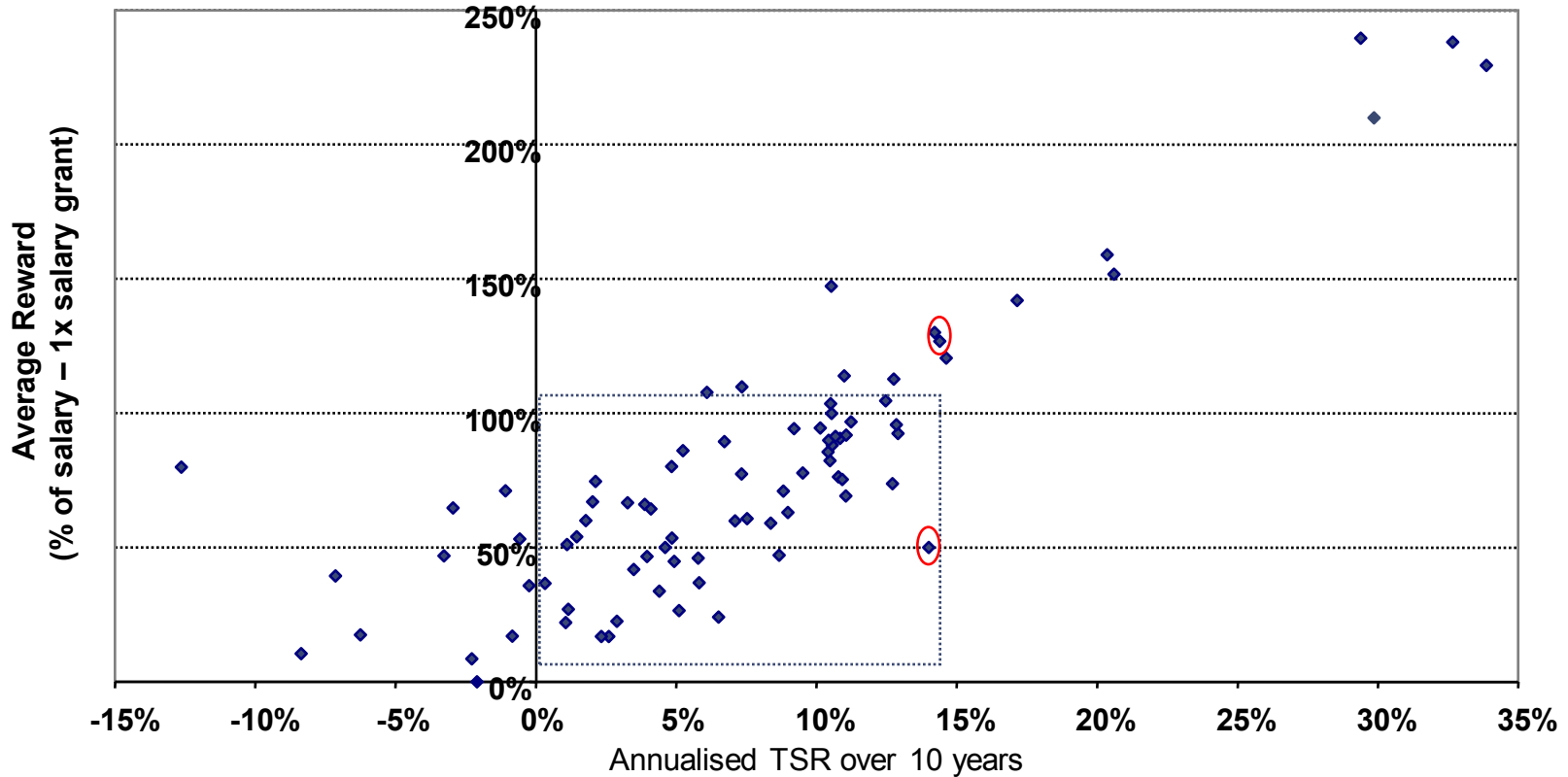
TSR plans – a key culprit

Typical TSR measure



TSR plans fail to deliver alignment

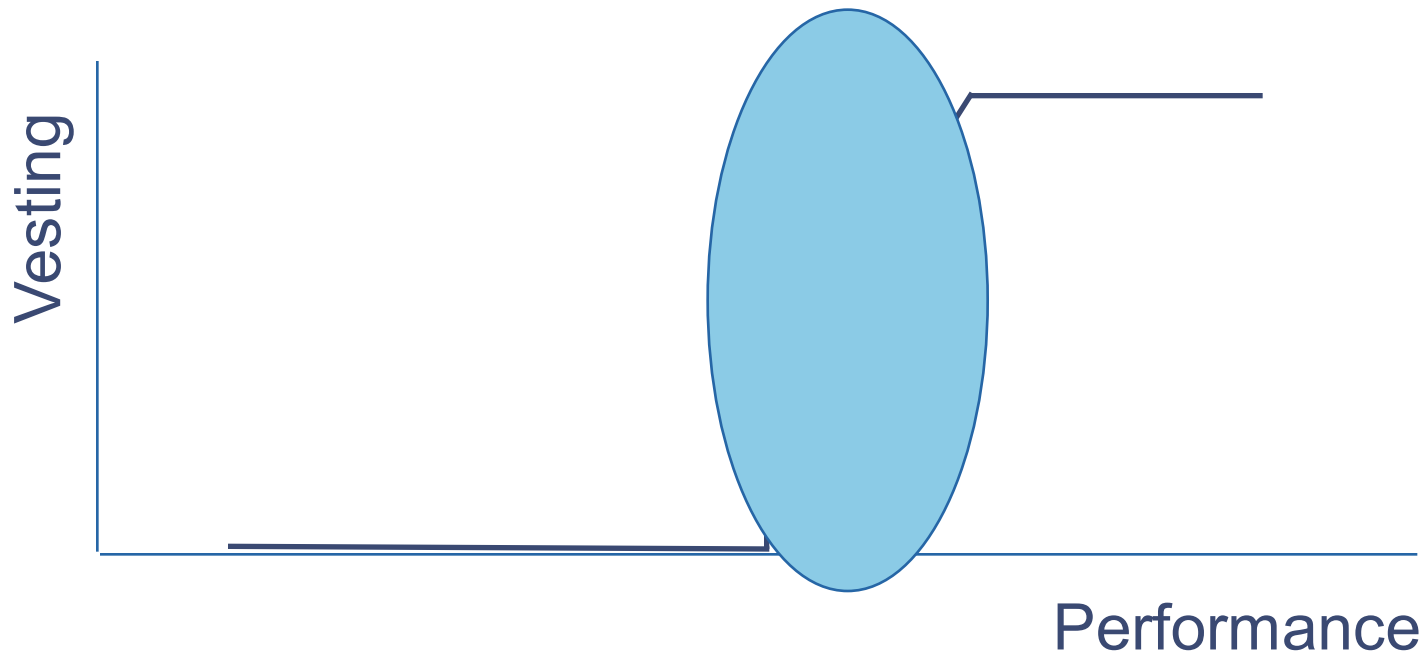
Reward versus Performance over 10 years
- Traditional TSR Measure



Performance shares, TSR measured relative to peer group

TSR rewards volatility...

Problems with out-performance philosophy

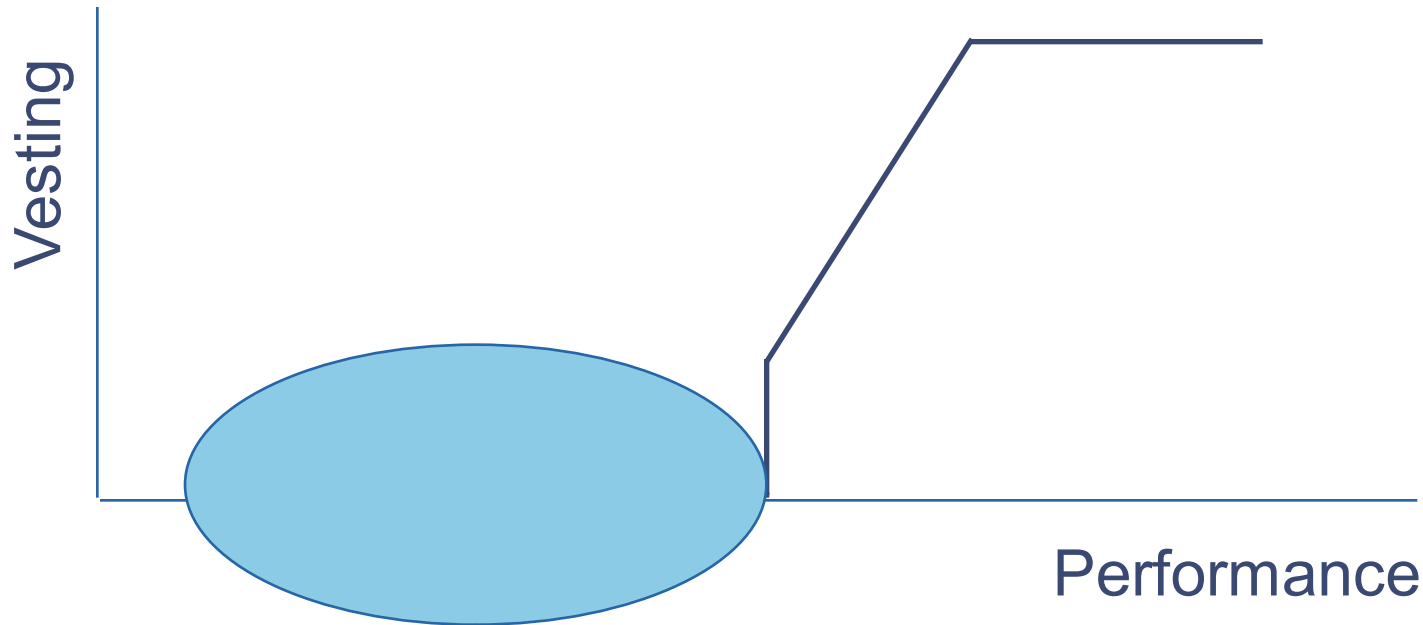


Zone of discrimination too narrow

→ Rewards volatile rather than sustained performance

...and fails to motivate executives

Problems with out-performance philosophy

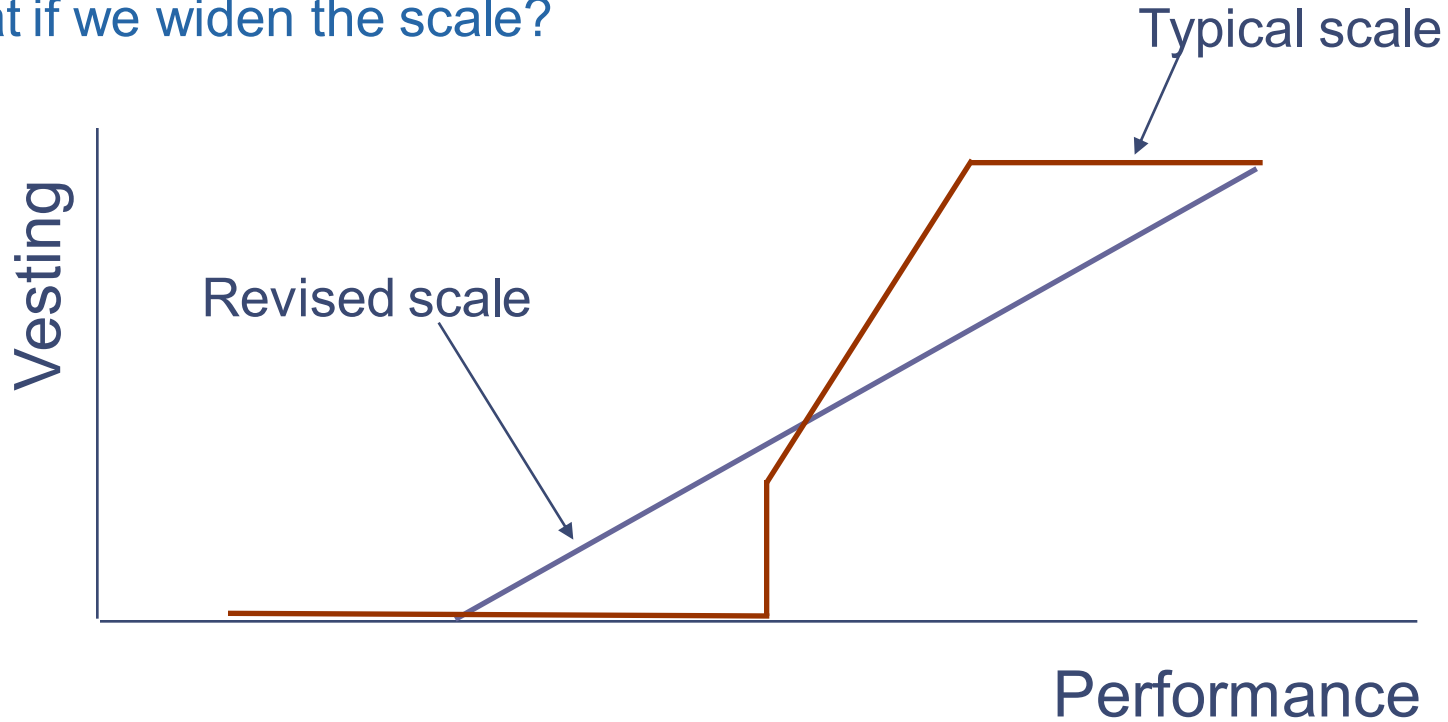


Zone of demotivation too wide

→ Rewards significantly discounted by executives

How to solve the problem?

What if we widen the scale?



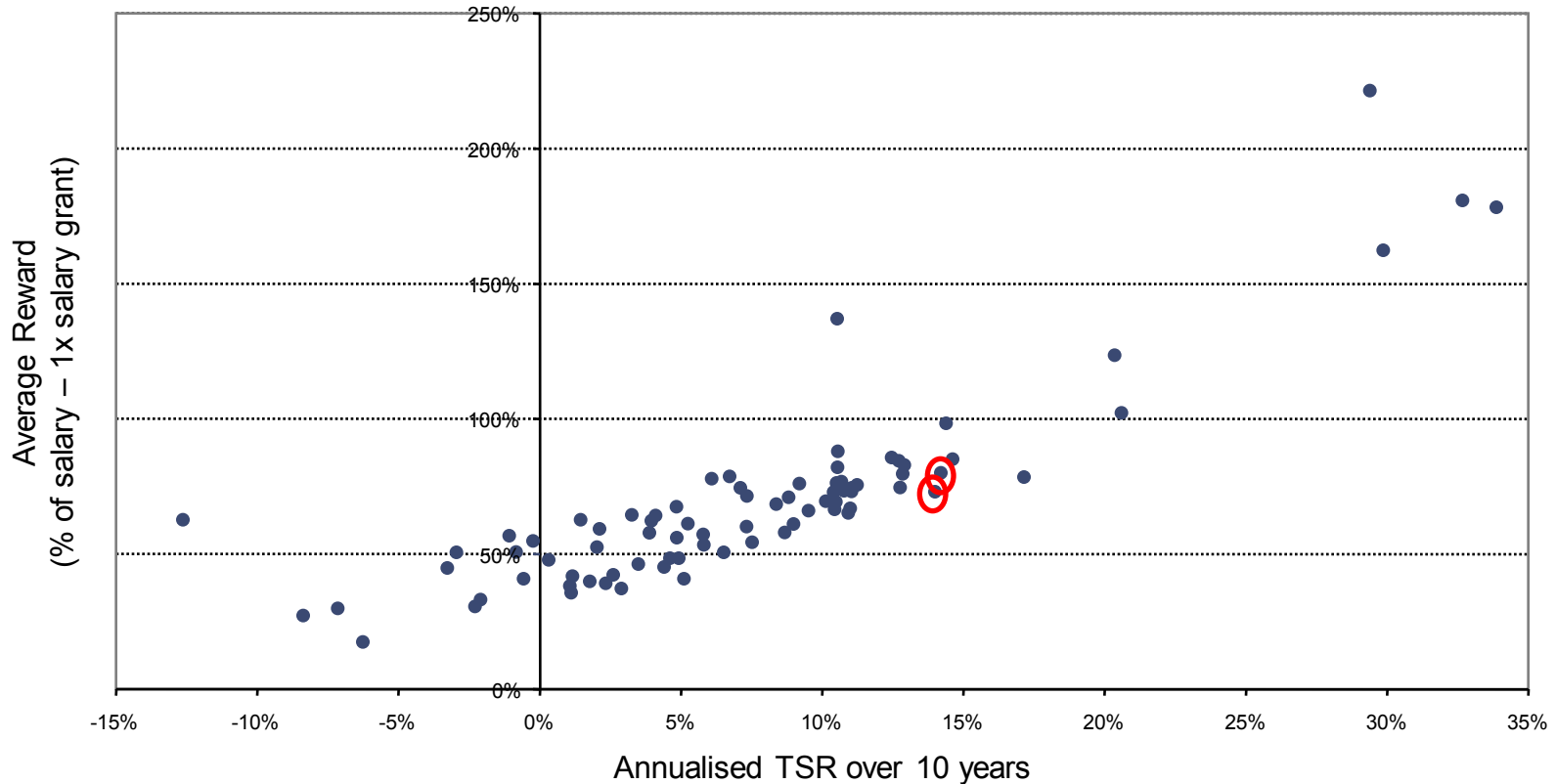
Zone of discrimination increased

Zone of demotivation decreased

Wider scales deliver better alignment

Outcome from wide-scale measure

**Reward versus Performance over 10 years
- Alternative TSR Measure (Wide-Scale)**

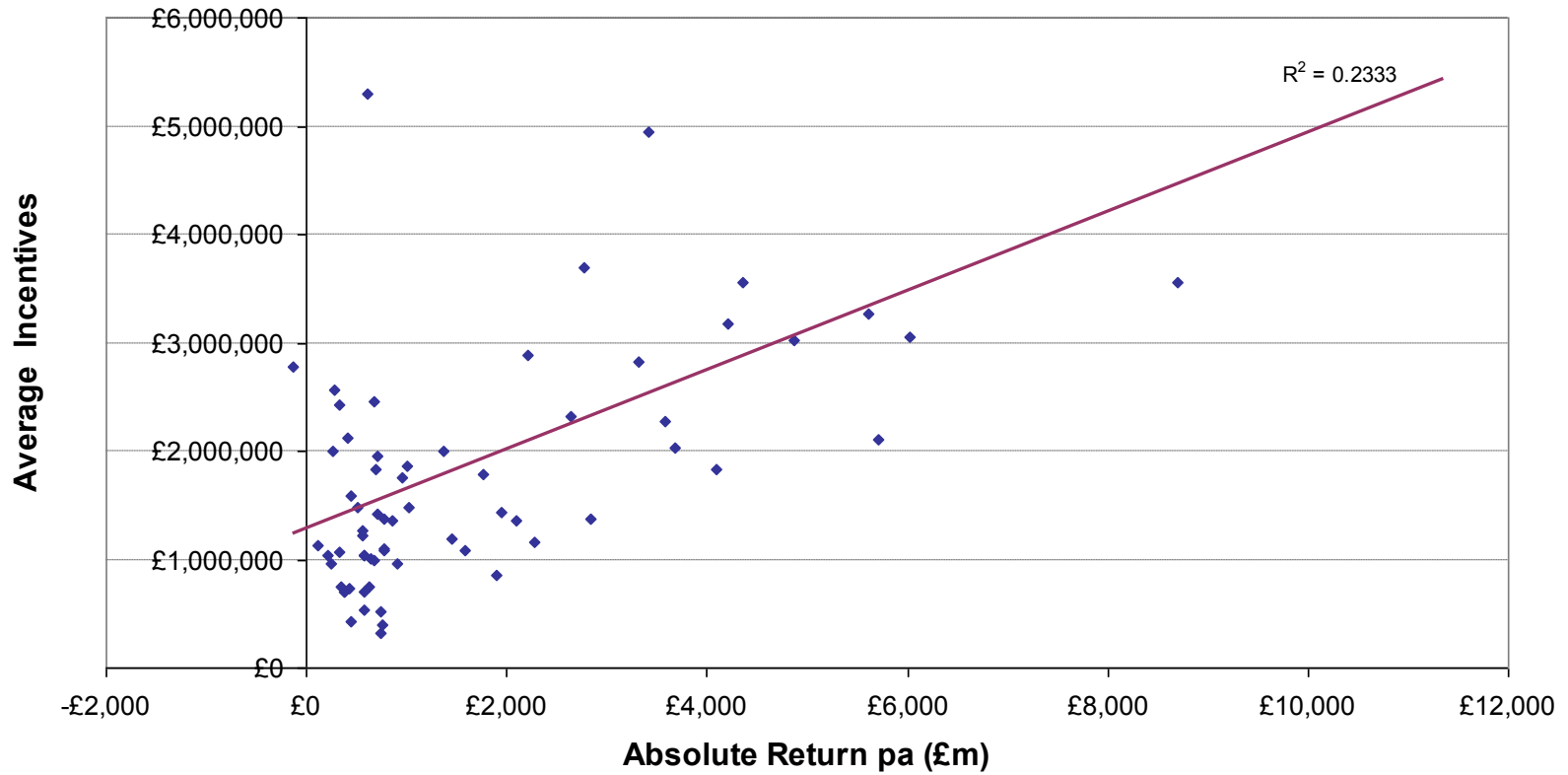


Why have performance conditions at all?

	Traditional design	Alternative design
Base salary	£800,000	£800,000
Bonus	150% of salary, 33% deferral	200% of salary 50% deferral
LTI	300% of salary maximum TSR / EPS scale	None
Restricted stock	None	150% of salary pa
Pension	40% of salary	None
Shareholding requirement	100% of salary	350% of salary
Total EV	c. £3m	c. £3m

What about that link with performance....

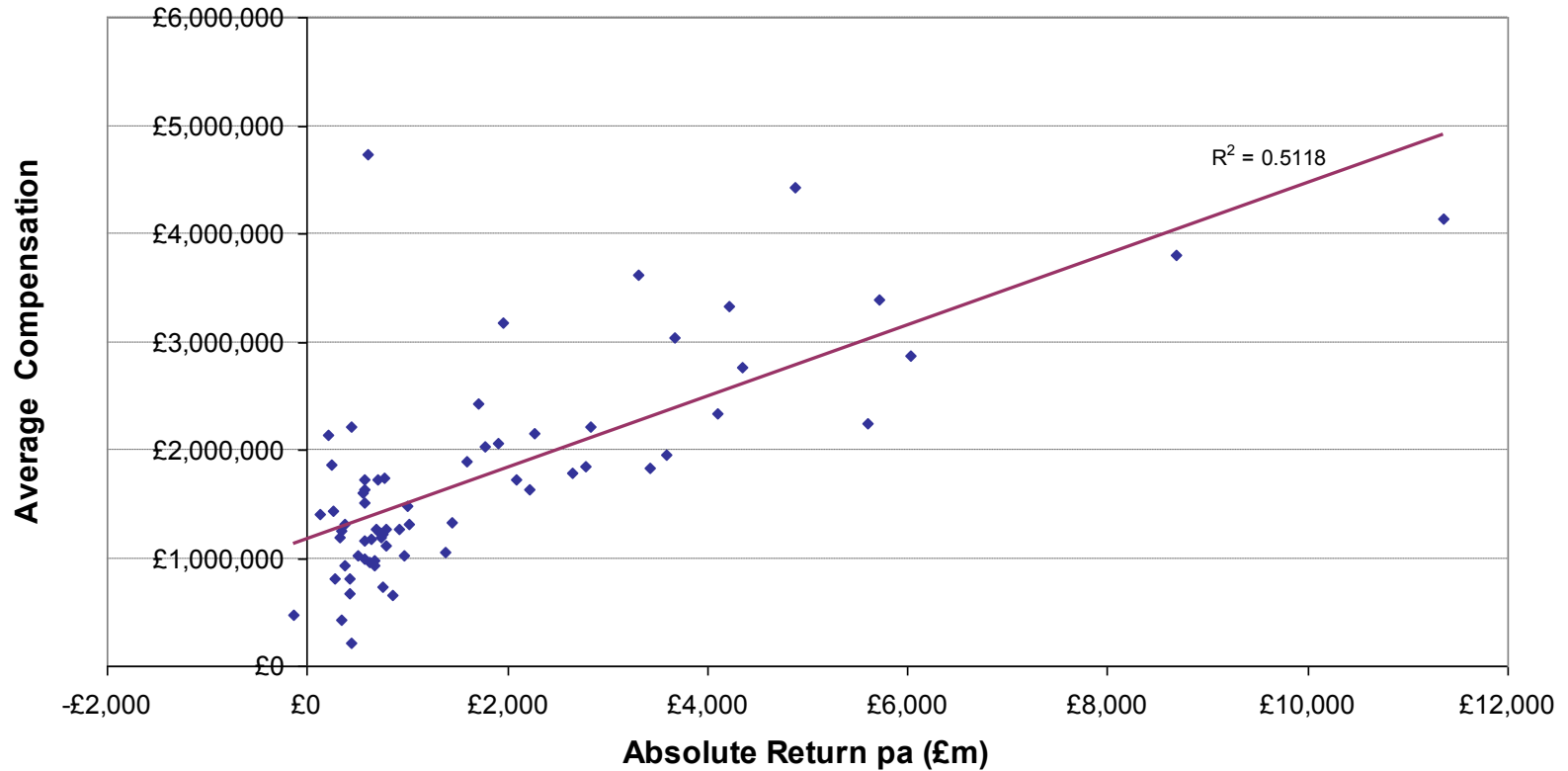
Incentives Versus Performance FTSE-100: 2001 to 2006



Source: IDS, Datastream, PwC Analysis

...it would actually be improved!

Incentives Versus Performance - Restricted Stock Model FTSE-100: 2001 to 2006



Pay for performance

- Currently not working
- Satisfying neither executives nor shareholders
- Shareholders need to recognise realities of motivation
- And companies need to be braver

- There is a simpler and better way!

Three mega-trends

3.

The Executive
Pay Explosion

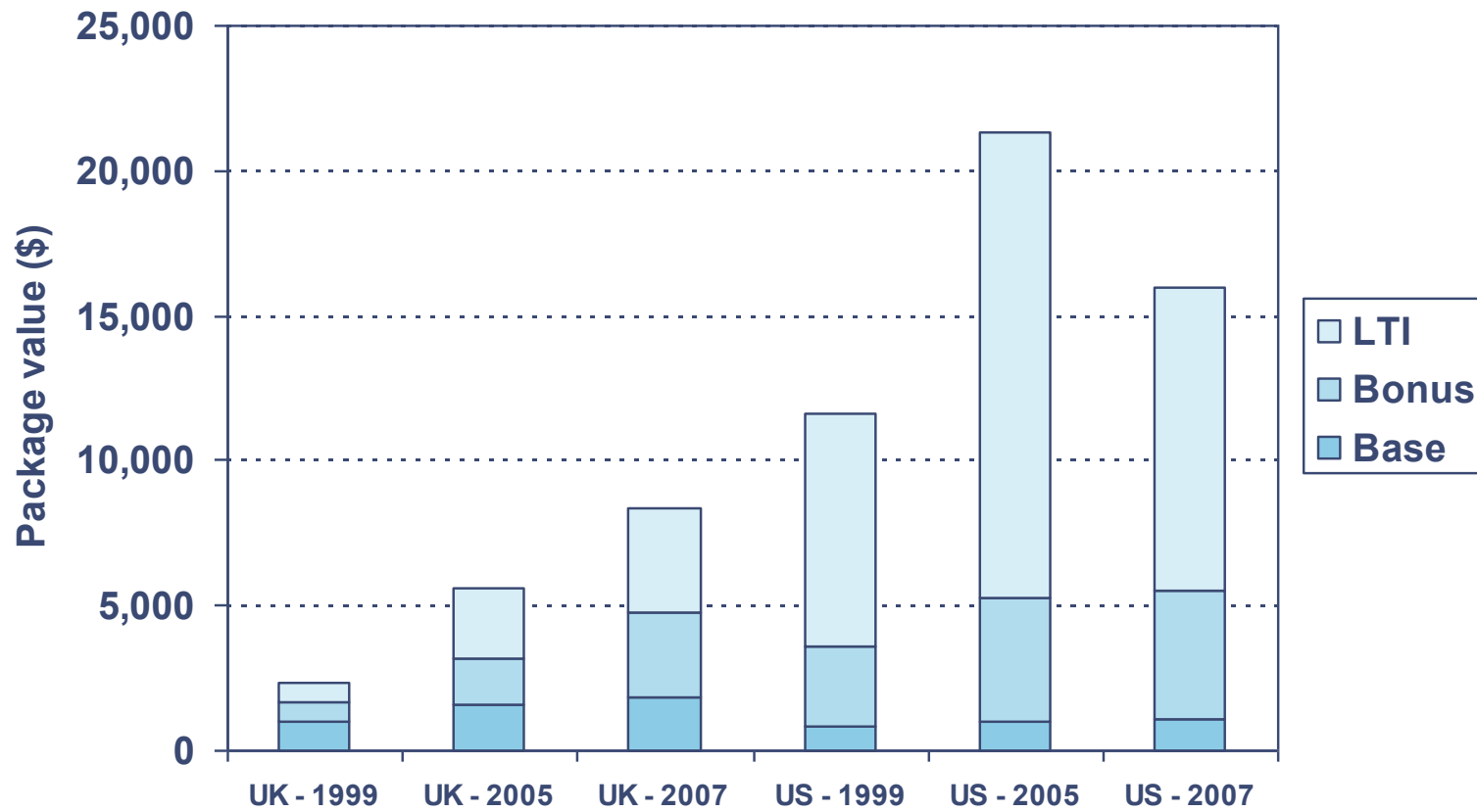
Superstar
Executives

Is the party
over?

The Executive Pay Explosion

Executive pay levels have grown and converged

CEO Package Values US and UK

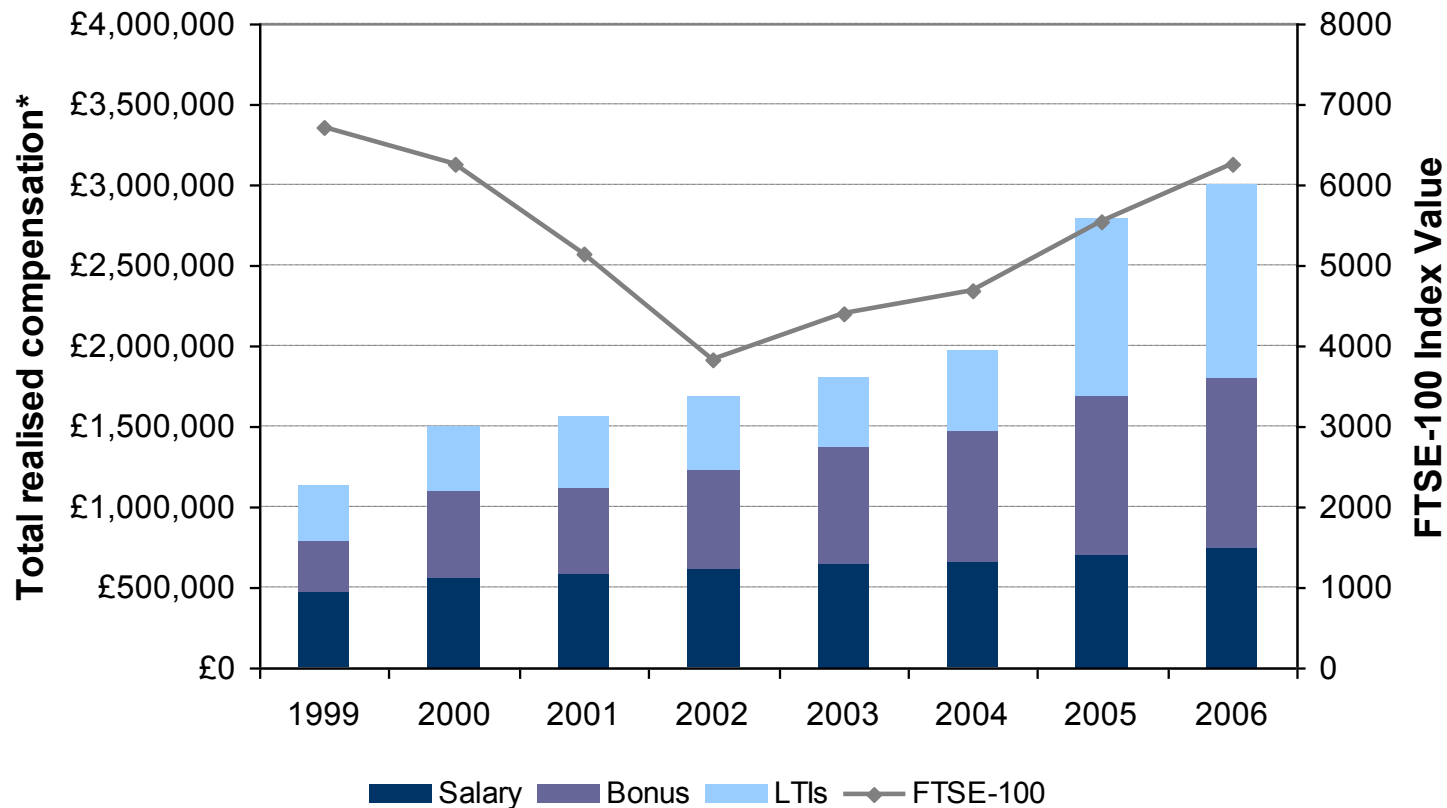


UK FTSE-50, US Fortune 500

The Executive Pay Explosion

UK executive *realised* pay grew steadily through 2001 downturn

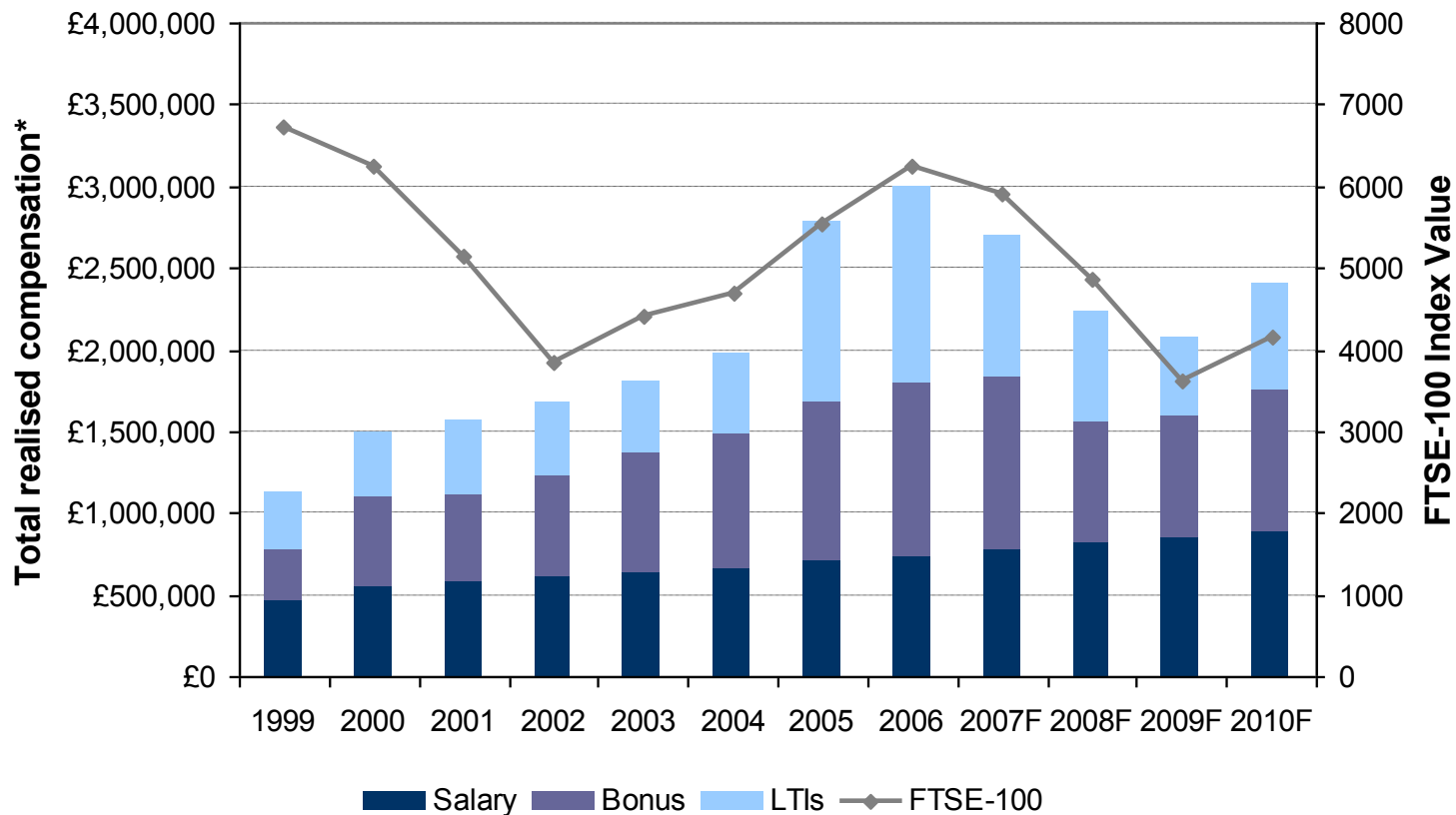
Average payouts - FTSE 100 CEO



The Executive Pay Explosion

But this is unlikely to be repeated this time round

Average payouts - FTSE 100 CEO



Evidence of resistance already

- Resetting of targets
- Package mix and measures
- Use of restricted stock / non-performance plans

Resetting of targets

HBOS reduced targets on past and future awards

- HBOS – UK bank
- Increased bonus opportunity
- Lowered LTI targets
- On future and past awards

“The Committee must ensure that, in what is anticipated to be a lower growth era, our incentives will continue to assist with the attraction, retention, engagement and motivation of all our colleagues.”

Resetting of targets

MDC repriced options and introduced new bonus targets

- MDC Holdings
- Major US house-builder
- Affected by subprime
- Stock-price fall from high of c. \$90 to low of c. \$30
- Introduced wide range of financial and non-financial bonus targets
- Proposed option repricing

Use of restricted stock

Significant resistance in Europe to use at board level

Company	Issue	Vote in favour (including abstentions in total cast)
Philips	Options without performance conditions	43%
GSK	£2.5m restricted stock	61%
Shell	Discretion to vest LTIP restricted stock award	51%
BP	£1.5m restricted stock awards	64%

But the world is changing

The Daily Telegraph

B&B and HSBC cut hundreds of jobs

guardian.co.uk

UBS faces further \$5bn writedowns

DOW JONES

Bank of America to buy Merrill Lynch for

Manchester **Evening News**

Britain's fifth-biggest mortgage lender, is granted emergency funding by the Bank of England

FT FINANCIAL TIMES

Lloyds seal \$22bn rescue deal for HBOS

CNN Money.com
A Service of CNN, Fortune & Money

JP Morgan buys Washington Mutual for \$1.9bn after US government shuts the bank down

THE TIMES

Citi may take \$20.8 bln more write-downs

The Herald

HBOS declines 18% to 232.5p, extending this year's decline to 68%

THE WALL STREET JOURNAL

Bear Stearns is bought by JPMorgan Chase for £120 million, having been valued at £9 billion a year earlier

And getting increasingly angry

“Modern devotion to the free market is a form of idolatry - Marx was right in his analysis of the power of unbridled capitalism“

The Archbishop of Canterbury, Dr Rowan Williams

“I hope that these vultures are made to pay. If they have done anything illegal they should be brought before the courts. If not illegal, then something is wrong with the law and this needs to be addressed. On a purely personal level, I'd like to see them tarred and feathered and their Porsches torched.”

Contributor to newspaper website

“Bank robbers and asset strippers“

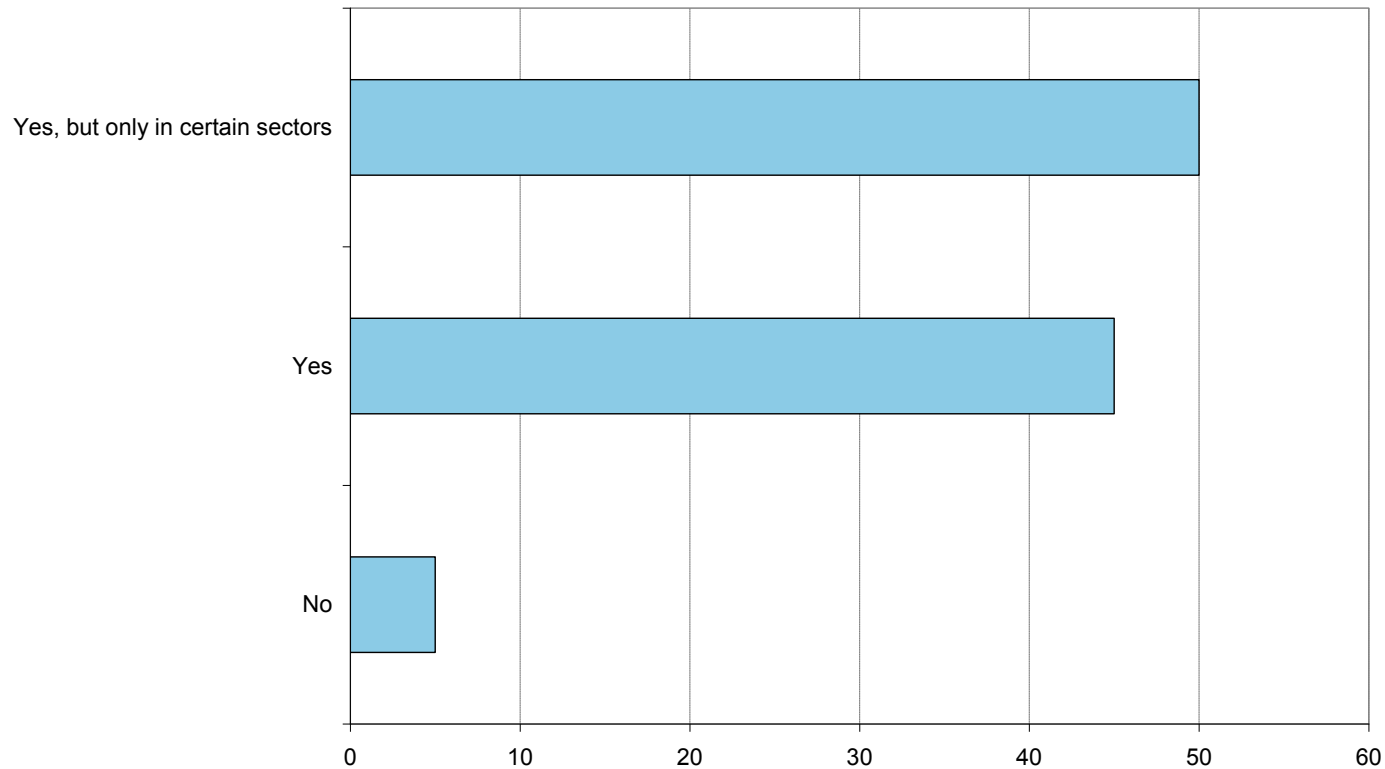
The Archbishop of York, Dr John Sentamu

But what is the real story?

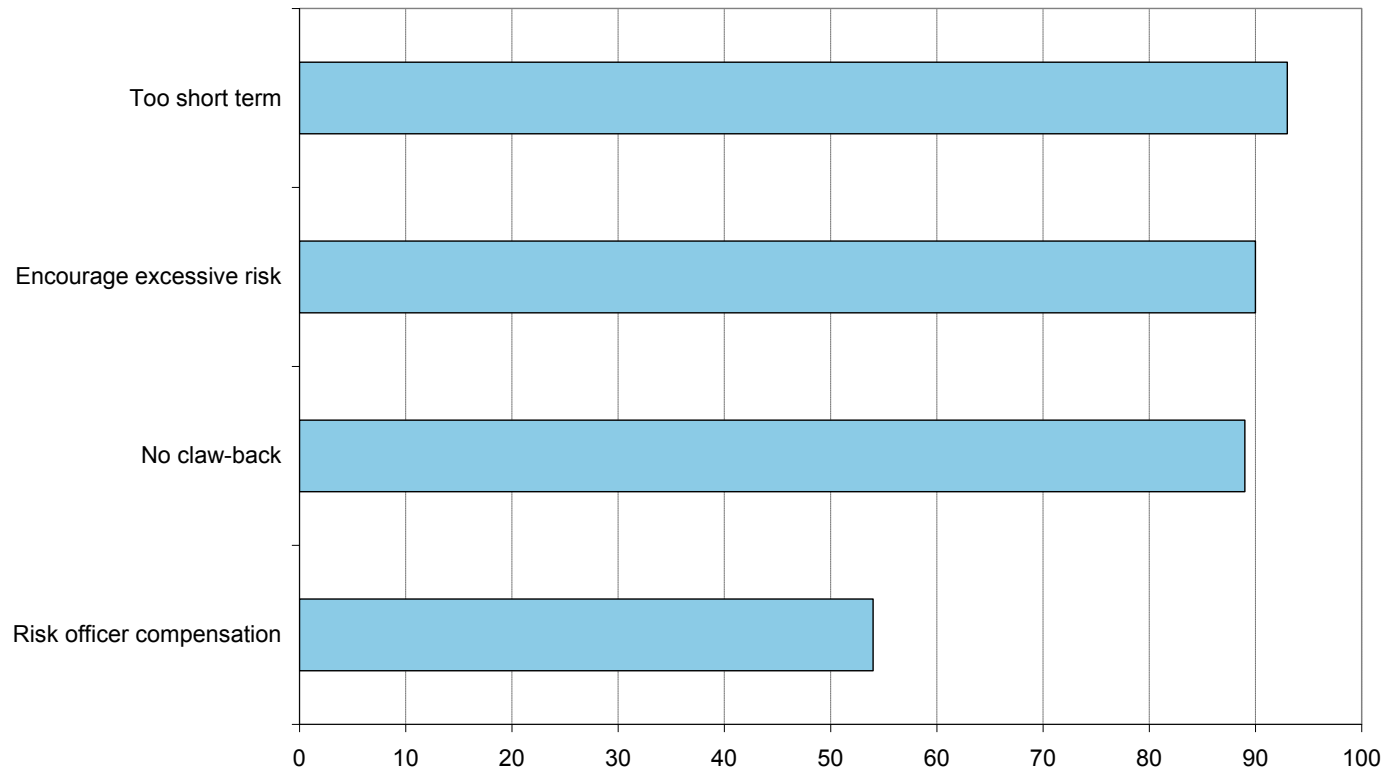
- PricewaterhouseCoopers commissioned the EIU to help with research
- Surveyed 264 senior participants from across financial services industry
- Interviewed prominent industry executives and commentators, including:
 - Andrew Moss - Chief Executive **Aviva Plc**
 - Sir Win Bischoff - Chairman of **Citi**
 - Edward Bonham-Carter - Chief Executive of **Jupiter Asset Management**
 - Michel Tilmant – Chairman of **ING**
 - Jon Peace- Chairman of **Experian**
 - Richard Kearns - CAO **Zurich Financial Services**
 - Paul Lee - Director, **Hermes Equity Ownership Services**
 - Sir Andrew Likierman of the **London Business School**
 - Peter Montagnon- **Association of British Insurers**

Overwhelming consensus that the way in which people are rewarded needs to be changed

Is compensation in financial services in need of reform?



So what do people think are the problems with reward systems...



"There is a risk that the remuneration systems are too short-term and that they do incentivise behaviour which is not helpful in terms of maintaining long-term financial stability."

Hector Sants, Chief Executive, FSA

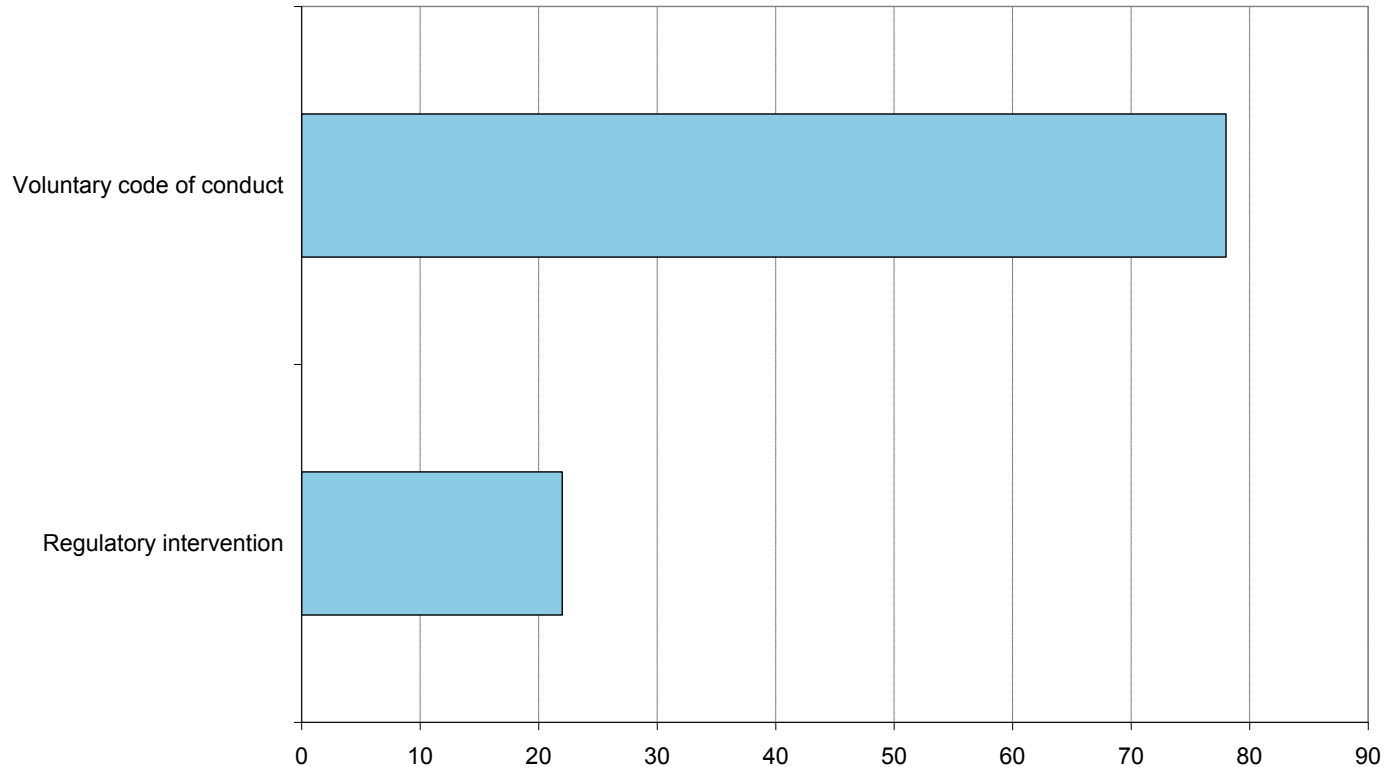
PwC view – reward issues

Issues

- Reward was not the cause of the credit crunch...but it added fuel to the fire
- We need to see:
 - more long-term incentives at board level *shareholders will demand it*
 - more focus on group performance to *avoid the risks of “eat what you kill”*
 - revamped deferrals *to align reward with business unit value*

How will change happen in the sector?

Would you support either of the following in relation to reward?



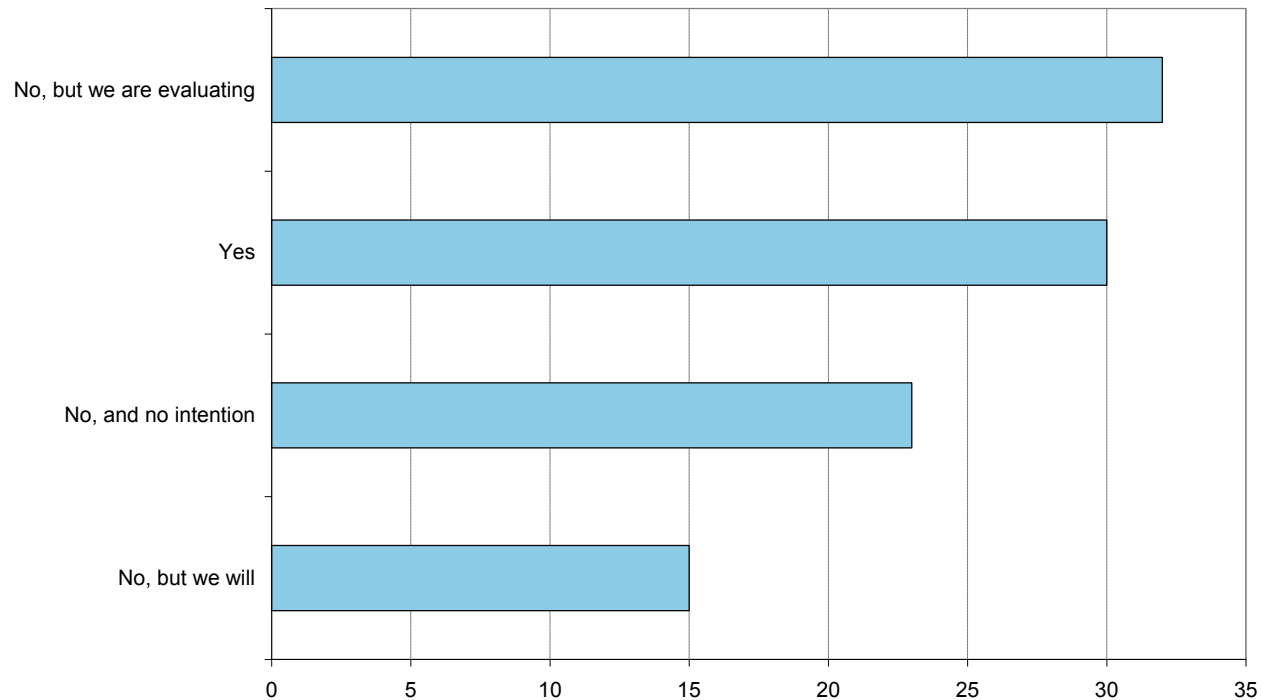
PwC view – achieving change

Issues

- Banks understandably nervous of moving first
- But the regulators will take a stance on this so change will come and banks need to be ready
- We need to see:
 - guidance from regulators *to act as a catalyst for change*
 - banks reviewing their reward risk *to be ready for the regulator*
 - a collaborative approach between regulators and industry *to get a system that works*

The use of risk based metrics when calculating bonuses will be key to addressing the issues

Do you use a risk-adjusted bonus metric?



Consideration should be given to ways through which the financial targets [for] compensation ... can be measured on a risk-adjusted basis.”

IIF Committee on Market Best Practices

But it is not all about reward

*Metrics that take account
of risk adequately*



*HR integrated with
risk and finance*



*A culture emphasising
sound risk practice*



*Systems biased towards
rewarding long term and team
behaviour*

Prospectus for reform- what did we conclude?

How would your organisation “comply or explain” against the following principles

1. Incentive payments should be based on performance measures that adequately account for the risk taken in producing profits
2. Bonus pools should not be struck below the level at which cost and risk can be allocated
3. Rewards should be aligned with the time profile of the risk borne by the firm
4. Deferrals should be linked to the realised profitability of the business on which the bonus was based
5. Managers should have a significant proportion of remuneration based on divisional or group based bonuses
6. Compensation design should be considered a key business competence and resourced as such
7. Compensation should be viewed in conjunction with wider people management practices in order to support a consistent approach to achieving desired culture

And the FSA largely agreed

Principles issued in CEO letter on 13 October

Measurement of performance

- Based on profits
- Risk-adjusted
- Multi-year assessment
- Non-financial measures / behaviours

Composition of remuneration

- Sufficient fixed component
- Mix of cash and shares
- Major proportion of bonus deferred

Deferred compensation

- Significant % deferred
- Multi-year performance assessment
- Legally robust and enforced

Governance

- Remuneration Committee
- Strong role for HR and Risk
- Independence, conflicts of interest
- Separation of back office

Responses required by 7th November

Change is coming and the prepared will prosper

*Metrics that take account
of risk adequately*



*HR integrated with
risk and finance*



*A culture emphasising
sound risk practice*



*Systems biased towards
rewarding long term and team
behaviour*

What does it all mean?

- Incentives not working for executives or shareholders
- There are better and simpler ways
- Companies and shareholders need to work harder to get there
- Assumption that executive pay always goes up to be tested
- The Regulators are coming and this may go beyond banks

- Many buffeting influences...
- ...never a more complex time to be in pay...
- ...and never more important to be clear on your principles

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