

THE BOARD OF DIRECTORS' APPROACH  
TO THE COMPENSATION OF  
THE BANK'S EXECUTIVES

FEBRUARY 23, 2010

**150** YEARS  
SINCE  1859



**NATIONAL  
BANK**

FINANCIAL GROUP

## Ladies and Gentlemen, Shareholders,

The Board of Directors (the “Board”) recognizes the importance of giving shareholders an opportunity to fully understand the principles on which we base our decisions about the compensation of the Bank’s executives, including how they are paid, and what they were paid in 2009. That is why, in February 2009, National Bank was the first Canadian bank to agree to put its approach to executive compensation to an advisory vote of its shareholders.

During fiscal 2009, the Board, supported by the Human Resources Committee (the “Committee”), took special care to review good governance practices with respect to compensation, given recent changes in compensation-related regulatory requirements and practices. In particular, the Committee, which is composed entirely of independent members, reviewed all the variable compensation programs applicable to executives, specialists in the Financial Markets sector, and all employees. The Committee members have extensive experience in executive compensation and risk management as a result of the diverse and strategic roles they have had in their careers. Nonetheless, the members request the advice of external specialists when they deem it appropriate.

### OUR PRIORITY: GENERATING A SUSTAINED AND GROWING LEVEL OF NET INCOME

The Bank’s primary objective is to generate growth in net income year after year in order to provide a steady return to its shareholders.

To achieve this objective, the management team adopted a clear strategy and a detailed transformation plan aimed at continuously improving customer service and revitalizing the organization’s growth so as to ensure its long-term sustainability. With this framework, the Bank can focus on its long-term priorities, while meeting short-term challenges.

We believe that the Bank’s continued success would not be possible without the contribution of talented, experienced and qualified executives and employees. In order to attract and retain these individuals in a fiercely competitive market, the Bank’s compensation policy and programs are designed around guiding principles.

### OUR GUIDING PRINCIPLES

Our principles are the following:

- **OFFER** competitive compensation in order to attract, motivate and retain qualified executives;
- **REWARD** executives for obtaining results that contribute to the Bank’s financial success in the short, medium and long term;
- **PAY** competitive compensation when results meet expectations, higher compensation when they exceed set objectives, and lower compensation when they fall short of expectations;
- **ENGAGE** executives to focus on enhancing the performance of the Bank and the value of shareholders’ investment;
- **REQUIRE** executives to hold a minimum number of common shares of the Bank in order to align their interests with those of the Bank’s shareholders.

### COMPENSATION TIED TO THE BANK’S PERFORMANCE

In keeping with our principles, we align compensation with the Bank’s performance. As a result, more than 75% of the target direct compensation of the named executive officers — the five most highly compensated executive officers — is variable or “at risk”. This means that the compensation depends on the extent to which a combination of corporate and individual objectives are achieved and the Bank’s share price. The compensation of the named executive officers consists of the following:

COMPONENTS		OBJECTIVE AND RISK/RETURN LINK
<b>Fixed:</b>	Base salary	It recognizes the level of responsibility, expertise, competency and experience
<b>Variable:</b>		
• Short-term	Annual bonus	Its value is tied to the growth in net income available to common shareholders
• Mid-term	Performance Share Units (PSUs)	Its final value varies depending on the growth in the Bank's total shareholder return (TSR) over three years compared to that of the S&P/TSX Banks Sub-index
• Long-term	Stock options	Its final value is tied to growth in the share price over a maximum period of ten years
<b>Other:</b>	Employee benefits, pension plan and other perquisites	They provide executives with assistance and security

To make sure that executive compensation remains competitive, the Committee reviews yearly the target total compensation of executives, i.e., what is paid when actual results match the objectives set. To do so, the Committee considers the results of market studies that it requests from its external consultants, receives recommendations from the President and Chief Executive Officer on the compensation of his direct reports, carries out its own analysis, and then makes its recommendations to the Board.

#### WHAT CHANGES DID WE IMPLEMENT IN 2009?

During 2009, the Financial Stability Board<sup>1</sup> issued the Principles for Sound Compensation Practices, which are to be implemented under the supervision of the Office of the Superintendent of Financial Institutions. Other organizations promoting good governance also expressed their expectations. It was in this context that the Committee paid special attention to reviewing good governance practices with respect to compensation and aligning them more closely with our growth objectives. Among other things, it reviewed all the variable compensation programs applicable to executives, specialists in the Financial Markets sector, and all employees. The changes made are summarized below.

##### Annual bonus program was streamlined

We decided to use a single financial indicator: growth in net income available to common shareholders. This change sends the clear message to Management and all Bank employees who are eligible for this program that sustained growth in net income is essential for shareholders, and it is important to work together to achieve the ambitious growth objectives that we approve every year.

At the beginning of fiscal 2009, market expectations in relation to growth in earnings per share were below 1%. As a result, we set the growth objective at 1% for a target of \$752 million. However, the growth in net income available to common shareholders significantly exceeded this target, reaching \$795 million, a growth of 6.7%. Such results made it possible to generate annual bonus envelopes that were 30.23% higher than the envelopes that would have been created if growth had matched the initial objective of \$752 million.

##### Mid-term compensation more closely tied to shareholder return

We modified the mid-term variable compensation plan by adding a performance criterion tied to the growth of the Bank's total shareholder return over three years. This program is called the Performance Share Unit (PSU) Plan.

In particular, the growth obtained by the Bank is compared with the growth over three years of the S&P/TSX Banks Sub-index. If the Bank's growth exceeds the index, the value of mid-term compensation payable is increased, but no higher than 125%. If the Bank's growth is below the index, the value of compensation payable is decreased, but no lower than 75% of the value payable.

<sup>1</sup> The Financial Stability Board is an international organization that succeeded the Financial Stability Forum in April 2009. The Forum had been created by the G7 in order to promote the stability of the international financial system. In September 2009, the G20 endorsed the compensation principles and the application standards established by these organizations.

### Compensation programs aligned with prudent risk management

The Board pays constant attention to risk management. Consequently, we decided to integrate the Bank's Risk Management sector into the review process of the annual bonus programs. We also introduced stricter requirements for the compensation programs for executives and specialists of the Financial Market sector in order to make sure that they comply with the principles and application standards issued in 2009 by the Financial Stability Board. To counter potential excessive risk-taking, the following changes were made:

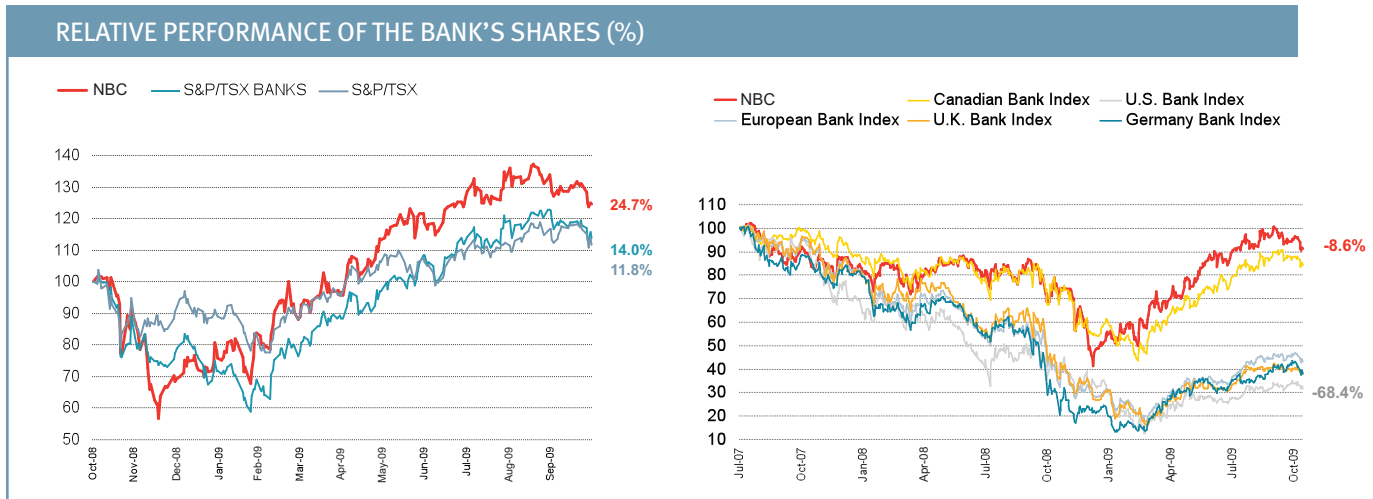
- The Bank must generate a specified level of net income available to common shareholders to trigger the payment of annual bonuses to executives, including the named executive officers.
- The compensation of the Executive Vice-President, Financial Markets and Co-President and Co-Chief Executive Officer of National Bank Financial was reviewed. Since 2009, a portion of his annual bonus has been tied to the growth in the Bank's available net income, like that of the other members of Management.
- The deferred portion of the annual bonuses for executives and specialists of the Financial Markets sector was increased. It is worth recalling that in 2001 the Bank was at the forefront when it introduced the requirement that executives in the Treasury and Financial Markets sector defer 30% of their compensation.
- A provision making it possible to claw back deferred compensation for executives and specialists of the Financial Markets sector was introduced. Deferred bonuses can now be clawed back when an employee is found guilty of dishonesty or unethical behaviour or misconduct and losses are incurred in that fiscal year or subsequently, or when employee compensation is based on the financial results of a business unit and those results must be restated and reissued.
- In order to include executives and certain senior specialists of the Financial Markets sector, we widened the application of the requirements for minimum holdings of Bank common shares. These employees' share holdings must now be equal to twice the average of their base salary for the previous three years.

### THE BANK'S OVERALL PERFORMANCE IN 2009: A KEY FACTOR IN OUR DECISIONS

The Bank's overall performance is an important factor that guides our decisions in determining the compensation of the named executive officers. The past few years have been difficult for European and North American financial institutions; neither their shareholders nor National Bank escaped unscathed. In 2007, the crisis of confidence in the financial industry that triggered a liquidity crisis in Canada linked to asset-backed commercial paper (ABCP) and the significant economic slowdown that followed in 2008-2009 created a very challenging environment for achieving growth objectives. Despite this difficult context, the Bank's results for 2009 were among the best ever recorded. Here are a few highlights:

- Diluted earnings per share, excluding specified items, reached a record high of \$6.22, demonstrating the strength of the Bank and the appeal of its reputation despite the prevalent economic uncertainty throughout the year;
- Through prudent risk management, the exceptional quality of the credit portfolio was sustained;
- The capital base remained strong as did the liquidity position;
- Dividends were maintained and no common shares were issued to raise capital, allowing shareholders to benefit fully from strong financial results, without any dilution;
- In 2009, as in the previous three years, the relative performance of the Bank's shares (TSX: NA) exceeded that of the Canadian, U.S. and European markets.

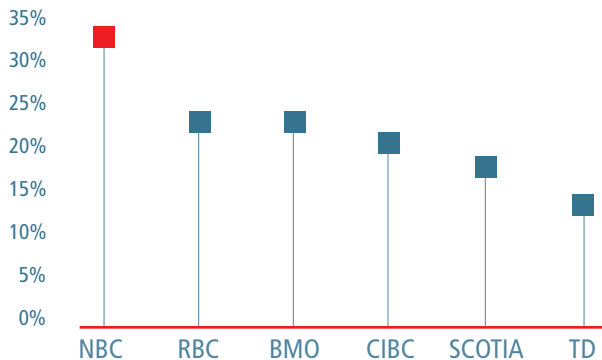
The following two charts show the relative performance of the Bank's shares.



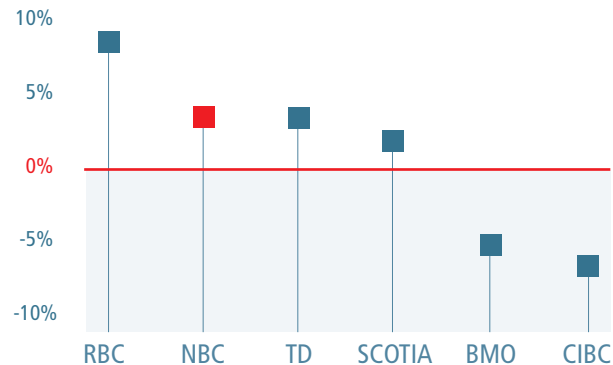
### TOTAL SHAREHOLDER RETURN (TSR)

These two charts highlight the Bank's total shareholder return (TSR), compared to the Big 5 banks, for the past year and the past three years.

TSR 1 year - At October 31, 2009



TSR 3 years - At October 31, 2009



### COMPENSATION OF THE PRESIDENT AND CHIEF EXECUTIVE OFFICER: performance-based compensation

The compensation of President and Chief Executive Officer Louis Vachon is based on the extent to which ambitious quantitative and qualitative performance objectives are achieved. At the start of the fiscal year, the Board approves Mr. Vachon's financial and non-financial objectives, which are taken into consideration when determining his annual bonus. In 2009, Mr. Vachon exceeded the following three financial objectives:

- Growth in diluted earnings per share of 6%, compared to an objective of 1%;
- Increase in revenues of 7.5%, compared to an objective of 1.9%;
- A loan loss ratio of 32 basis points, compared to a target range of 35 to 40 basis points.

Furthermore, Mr. Vachon achieved all of his objectives linked to implementing the Bank's *One client, one bank* strategic approach:

- A new client-centric distribution model was deployed;
- A consolidated Operations group was formed;
- The organizational structure and the roles of more than 4,000 employees in Head Office sectors were reviewed;
- Progress was made in building a client-centric corporate culture based on cooperation, rigour and accountability.

The following variable compensation envelopes were generated when the various programs were applied:

	BASE SALARY	X	TARGET %	X	APPLICATION OF PROGRAM	=	AMOUNT GENERATED (rounded)
Short-term	\$850,000	X	125%	X	130.23%	=	\$1,400,000
Mid-term	\$850,000	X	150%	X	100.00%	=	\$1,275,000*
Long-term	\$850,000	X	250%	X	100.00%	=	\$2,125,000*

\* These amounts represent the values when the awards were made. The final amounts will vary in accordance with the parameters of the respective programs.

The Board believes that the initiatives and strategies implemented as part of the *One client, one bank* transformation produce tangible results in the short term, favour the Bank's growth over the medium term, and ensure its long-term sustainability. The Board is therefore very satisfied with Mr. Vachon's performance in 2009 and approved variable compensation for him in accordance with each amount generated and presented in the above table.

During the year, the Board also approved an increase in Mr. Vachon's base salary to \$850,000. His base salary had not been adjusted since his appointment in June 2007. This decision was based on the results of an external market study mandated by the Committee. The adjustment represents an increase of 6.25% or 2.78% annually considering the 27-month period elapsed between June 1, 2007 and August 31, 2009. Despite this adjustment, Mr. Vachon's compensation still falls approximately 10% short of the peer group median cited in the study.

For 2009, Mr. Vachon's total direct compensation was therefore \$5,606,453, representing 6% more than his target compensation – the compensation he would have received if he had delivered results equal to the objectives. The details of Mr. Vachon's compensation are presented on page 45 of the Management Proxy Circular sent to shareholders for the Annual Meeting on March 31, 2010.

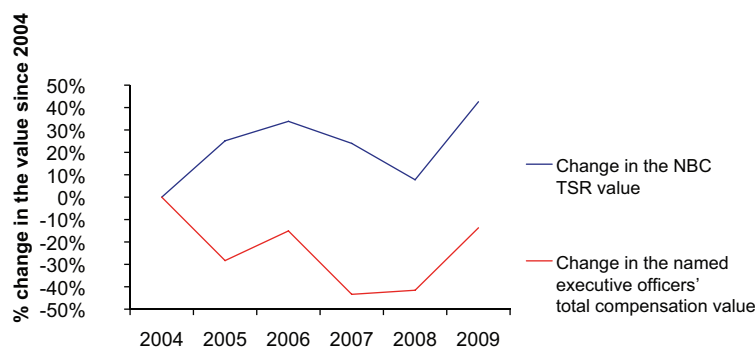
Therefore, this 6% increase compared to the target compensation is aligned with the 5.8% growth in earnings per share and the 6.7% growth in net income attributable to common shareholders for the fiscal year ended October 31, 2009.

In 2008, Mr. Vachon's total direct compensation was 5% lower than his target compensation then in effect or \$4,743,900. In 2007, Mr. Vachon's total direct compensation was 22% lower than his target compensation at the time.

The Board requires that the President and Chief Executive Officer hold a minimum total share value equivalent to 5 times of his base salary for the previous three years. At the end of fiscal 2009, Mr. Vachon's shareholdings represented more than 19 times his base salary.

#### THE VALUE OF THE TOTAL COMPENSATION FOR 2009 WAS EQUAL TO THAT FOR 2006

The change in the value of the named executive officers' total compensation was similar to that of total shareholder return between 2006 and 2009, as shown in the chart below.



In 2009, the value of the total compensation of the five named executive officers (\$18.9 million) was equal to that for 2006 (\$18.6 million), while the cumulative return on an investment in the Bank's common shares made on October 31, 2004 was worth 42.57% more in 2009, compared to 33.85% more in 2006.

## OTHER CHANGES TO COME IN 2010

In order to further strengthen our good governance practices given the new expectations of regulatory organizations, other changes will be made to compensation programs in fiscal 2010. Here are a few examples:

- A trigger will be added to all variable compensation programs so that no bonus envelope can be created if the Bank does not meet the minimum regulatory capital required by regulatory authorities;
- Although a risk metric is currently used to determine the percentage of the annual bonus envelopes for certain groups in the Financial Markets sector, the Risk Management sector will develop a risk metric framework for establishing the value of the bonus envelopes for all groups in the Financial Markets sector;
- The Committee will receive, on an annual basis, a report from the Bank's Corporate Compliance Department that identifies any significant discrepancies between the Bank's compensation policies, programs and practices and the regulations and standards in force;
- The Committee will also receive a report from the Bank's Internal Audit Department that identifies any significant differences between the compensation paid and payable under the Bank's total compensation policies and programs.
- The Committee members will attend training sessions to perfect their knowledge with regard to aligning compensation governance with prudent risk management.

## CONCLUSION

We are pleased to have this opportunity to explain the rationale for our approach to executive compensation. For more detailed information, please see Sections 6 and 7 of the Management Proxy Circular sent to shareholders for the Annual Meeting on March 31, 2010.

The Board has complete confidence in the management of the Bank and our institution's future. The Bank is built on a solid foundation and has a clear and targeted strategy. Its continued vigilance of risk management and stringent implementation of strategies will no doubt lead the Bank to new heights in customer service and in creating shareholder value in the years ahead.



Jean Douville  
Chairman of the Board of Directors



Jean Gaulin  
Chair of the Human Resources Committee