6. Q: What is the possible level of dilution if all targets under POP are met? (continued)

- **Scenario 2**

If EVA targets are only met and not exceeded, then this number falls to 14.6 million options. Of course, if the CAGR of GHL’s stock is 7% or below (the current risk free rate chosen by the GHL Board), then Zero options are granted.

Assuming the 12% CAGR and hitting 1.25 times EVA targets, your Board is requesting shareholders to approve 16.858 million new options (GHL currently have 1.142 million unallocated options), bringing the total available to be allocated to 18 million.

The 18 million of new options represents 7.76% of the current issued share capital of the GHL. The Institutional Shareholder Services (a shareholder watchdog) recommend guidelines for the amount of burn rate that companies should adopt. For the insurance industry that burn rate is 1.34% annually, which would translate to 6.7% over the requested 5 year POP plan period. We are supporting a slightly higher burn rate given the higher risk to the executives of the POP plan.

While the life of any given option awarded under POP is 10 years, the request is to authorise shares to fund the first five years of the plan. At the five year point, the plan will be evaluated, and if an additional allotment of shares is needed for continuation, it will be requested at that time.

7. Q: How can I be sure that the POP is a good investment of shareholder funds?

The POP is a good investment in the quality and effectiveness of GHL’s senior management team.

It provides strong incentive for the senior management to improve the economic performance of the company and thereby drive GHL’s share price. There is a safeguard in the form of a performance hurdle, i.e. rising exercise price on the POP option, which will ensure a threshold level of return to shareholders before management sees any reward through the option plan. This performance hurdle did not exist with SOPE, nor does it exist with the typical, conventional stock options plans. The POP will further strengthen and align the interests of managers and shareholders towards growth in the GHL share price and enterprise value. The Ontario Teacher’s Pension Plan, a leading Canadian institutional investor, states: “We will generally support plans that link the granting of equity incentives, or the vesting of equity incentives previously granted, to specific performance targets.” The plan is thus generally aligned with expectations of leading institutional investors.
1. Q: What is a Performance Option Plan (POP)?

A POP is a type of stock option plan but differs very significantly from the stock option plan GHL operated until now, which – for the purpose of this note – we refer to as the SOPE.

SOPE, which is similar to the majority of stock option plans, a stock option was granted to the executive. This option bestowed upon the executive a limited right to purchase up to a certain number of shares of GHL at a stated strike or exercise price. The strike price was set at the three day average price of GHL’s market price prior to the granting of the option (typically April 1 of each year). The executive’s ability to exercise the option (by paying the strike price in cash) vested after two years, but only if the executive remained with GHL. Exercising the option, when in the money (meaning that the actual market price is greater than the strike price), entitled the executive to purchase the actual share for the exercise price. The difference between the strike price and the actual market price at the time of exercise netted the executive a capital gain.

Instead of having a fixed strike price, the POP’s strike price will be increased annually at a pre-determined growth rate as recommended by the GHL Remuneration Committee and approved by the GHL Board.

2. Q: Why is GHL moving from SOPE to POP?

1. The current allotment of options approved by GHL’s shareholders for the SOPE is near exhaustion so the Board has taken the opportunity to review and improve on the plan.

2. More importantly, the GHL Board and the Group CEO felt that SOPE, and most stock option plans in general, were not delivering the kind of incentives necessary to drive shareholder value, while at the same time diluting existing shareholders. Conventional stock option plans give the holders all the upside of share price appreciation, with none of the downside risk of share price depreciation – much different from buying shares on the open market. It was therefore decided to undertake a review to see what changes could be made to improve SOPE.

GHL hired Stern Stewart, who helped the Group formulate and implement its Economic Value Added (EVA) plan, to assist in devising an appropriate replacement. The changes proposed for SOPE will convert it into a POP plan which, we believe, will correct the inherent weaknesses of SOPE.

3. Q: What are the key elements of POP and its advantages to SOPE?

While the POP is similar in function to the SOPE, the key significant differences are:

i. The option exercise price, or strike price, grows annually at a predefined rate. This rate will be targeted at the GHL risk free rate and ultimately set by the GHL Board.

ii. The exercise period, or the period of time during which the holder of the option may exercise his option, will be shortened. Under SOPE the exercise period is 10 years after a 2 year vesting period. Under the new POP, the exercise period is 8 years after a similar 2 year vesting period.

With POP’s feature being an ever increasing exercise price over its 10 year life, its main benefit is that it guarantees a return to shareholders before management shares in the increase in the value of GHL’s equity. In other words, the POP options will not be in the money, and therefore cannot be exercised, until the minimum growth rate is achieved. SOPE does not provide for any threshold level of return as the option exercise price is set and fixed at the share price at the point of grant.

Under POP there is a much better alignment between shareholders and management, with management being incentivised to drive share price above the minimum growth rate as approved by the Board of Directors.

4. Q: Why does GHL need a stock option programme?

Top quality executive management generally is both tough to find, and retain. GHL operates across many jurisdictions and competes for talent on a regional and international basis. Equity incentive plans provide an important tool for GHL in this quest for talent. In addition, equity based incentive plans create share ownership, along with its attendant risks and rewards, among the managers who direct the strategies and operating decisions of a company. Share ownership helps align the goals, objectives and rewards of managers and shareholders in a very direct way, ideally resulting in better corporate performance and results.

The Remuneration Committee, the GHL Board, and the Group CEO have undertaken an exhaustive review of GHL’s overall compensation and benefit policy. The basic philosophy adopted has been that the fixed part of our executive’s pay should be competitive within local market standards and provide a basic standard of living commensurate with their position. The variable part of their pay should have both a short term component and a long-term component which drives annual performance and share price appreciation respectively.

It should be noted that the number of executives eligible for POP will be much more limited than under SOPE. Under POP only the most senior executive will be eligible and currently the number is 14. Arguably, managerial participation in SOPE was too broad. Academic research indicates that, at lower levels, equity does not provide much incentive but is rather viewed as a windfall in good times and a potential disincentive in bad times. At lower levels of management, equity does not create the sense of ownership and alignment since executives at this level feel that they cannot directly influence share price movements. For that reason POP will only be applied to those at the most senior levels of the organisation.

The introduction of EVA in 2010 provides annual performance incentives; POP will drive long-term share price appreciation.

The revamping of GHL’s incentive based compensation plans is now much better aligned to shareholders and places GHL in unique company, being among the most shareholder friendly companies when it comes to executive compensation (90% of companies that offer stock option plans offer “straight options” without an increasing exercise price, and the great majority of annual, cash based incentive plans do not consider the cost of capital in determining payouts and are not annual improvement plans like EVA).

5. Q: Will this plan dilute my ownership and economic rights?

While more options may be granted under POP (relative to SOPE and because POP is a much more risky plan for executives), the likelihood of any given option being exercised is lower, given the presence of the performance hurdle. So while dilution may occur, it is only after the actual share price appreciates at a greater rate than the POP exercise price growth rate. If actual, annual share price appreciation exceeds the annual POP growth rate, shareholders should want to reward their executives for their performance.

In addition, since it is viewed by the GHL Board and the Group CEO that the current GHL share price undervalues the company, an additional safety valve was built into POP which limits dilution by introducing an $18 floor exercise price. This means that any improvement in the current share price up to $18 will first benefit existing shareholders, as POP options cannot be exercised until this floor has been penetrated. In order to compensate the executives for this, an adjusted exercise price has been calculated by Stern Stewart. Therefore:

- If the actual share price at the point of option grant is below $18, the Adjusted Exercise Price Growth Rate would be used as the basis of increasing the option exercise price of the said series of options. The computed adjusted exercise price growth rate would be held constant for the life of the said series of options (i.e. 10 years).

- Otherwise if the actual share price at the point of option grant is above $18, the Base Exercise Price Growth Rate would be used as the basis of increasing the option exercise price of the said series of options, where the Base Exercise Price Growth Rate is set equal to the GHL Risk Free Rate, or that determined by the GHL Board.

6. Q: What is the possible level of dilution if all targets under POP are met?

Stern Stewart ran a simulation for GHL in order to answer this question.

- Scenario 1

Where GHL’s stock price grows at a compound annual growth rate (CAGR) of 12%, and EVA targets are exceeded by 25%, then in order to fund five years of POP, approximately 18.2 million options would be required.