

ONE CLIENT, ONE BANK

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

FEBRUARY 22, 2011



**NATIONAL
BANK**

FINANCIAL GROUP

Ladies and Gentlemen, Shareholders,

The members of the Board recognize 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 2010.

That is why we would like to present you the approach to executive compensation adopted by the Board and our appraisal of the performance of the President and Chief Executive Officer as well as our decisions concerning the compensation of the President and Chief Executive Officer.

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

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To achieve this objective, the Bank's management adopted a clear strategy and a detailed transformation plan called *One client, one bank*. The purpose of this transformation is to be a leader in client experience with the ability to provide best-in-class financial advice, solutions and service to Bank clients, regardless of their point of entry. With this framework, the Bank can focus on its long-term priorities, while meeting short-term challenges.

OUR COMPENSATION PHILOSOPHY

The Board believes that the Bank's continued success would not be possible without the contribution of talented, experienced and qualified executives and employees. To attract and retain these individuals in a fiercely competitive market, the Board has adopted a compensation philosophy based on the following guiding principles:

- OFFER **competitive compensation** in order to attract, motivate and retain qualified executives
- RECOGNIZE **executives' contribution** with fair and equitable compensation based on their roles and responsibilities
- OFFER **performance-based compensation, considering different time horizons and encouraging sound risk-taking**
 - PAY competitive compensation when results meet expectations, higher compensation when they exceed set objectives, and lower compensation when they fall short of expectations
 - OFFER a level of variable compensation that encourages reasonable risk-taking, which is in line with the Bank's risk appetite
 - ENSURE symmetry between the level of variable compensation and the level of risk incurred over time
 - 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.

HOW WE HAVE ALIGNED COMPENSATION WITH RISK MANAGEMENT PRINCIPLES

The Human Resources Committee (the "Committee") ensures that the Bank's compensation policies and programs respect the regulations and standards in effect, promote sound risk management and make sure that compensation paid is closely tied to the Bank's financial performance and shareholder return.

Given the changes in the regulatory and prescriptive frameworks and latest best practices, here is an overview of the changes made over the past two years.

ANNUAL BONUS PROGRAM STREAMLINED

- A single indicator, available net income, was introduced.
- A specified level of available net income must be generated to trigger the payment of annual bonuses.

DEFERRED ANNUAL BONUSES

- The deferred portion of annual bonuses was increased for executives and specialists of the Financial Markets sector; this deferred portion is awarded in the form of Restricted Stock Units.

PERFORMANCE CRITERIA

- The mid-term variable compensation plan offered to the Named Executive Officers is tied to the relative growth of the Bank's total shareholder return over three years.

MINIMUM SHAREHOLDINGS

- The executives and certain specialists of the Financial Markets sector must own a minimum number of Bank common shares.

HEDGING TRANSACTIONS PROHIBITED

- The purchase of financial instruments designed to hedge against a decline in the value of equity-based compensation is prohibited.

CLAWBACK PROVISION

- A clawback provision was added for the deferred compensation of executives and specialists of the Financial Markets sector in certain circumstances.

ANNUAL BONUS TRIGGER

- No annual bonus envelope can be created if the Bank does not meet the minimum regulatory capital required by regulatory authorities.

Also, in accordance with Standard 15 issued by the Financial Stability Board in September 2009, National Bank decided to voluntarily publish and post on its website the compensation paid in 2010 to the members of its personnel who may have a material impact on the Bank's risk profile.

COMPENSATION TIED TO THE BANK'S PERFORMANCE

Our guiding principles favour tying compensation to the Bank's performance. As a result:

- More than 75% of the target direct compensation (the compensation paid when results meet objectives) of the Named Executive Officers is variable or "at risk"
- Such 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 includes the following elements:

ELEMENTS OF TOTAL COMPENSATION	
Fixed:	Base salary
Variable (at risk, based on performance):	
• Short term	Annual bonus ✓ Linked to the growth in available net income ✓ Trigger: threshold for available net income
• Mid term (deferred compensation)	Performance share units (PSUs) ✓ Final value at risk ✓ Known after 3 years ✓ Performance criteria: relative TSR
• Long term (deferred compensation)	Stock options ✓ Linked to the price of the Bank's common shares
Other:	Employee benefits, pension plans and perquisites

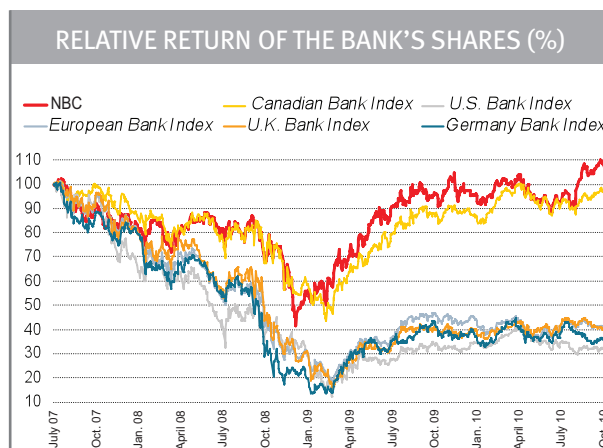
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To make sure that executive compensation remains competitive, the Committee annually reviews the target total compensation of executives. To do so, the Committee considers the results of market studies that it commissions from independent external consultants, receives recommendations from the President and Chief Executive Officer on the compensation of the members of the Office of the President, carries out its own analysis, and then makes its recommendations to the Board.

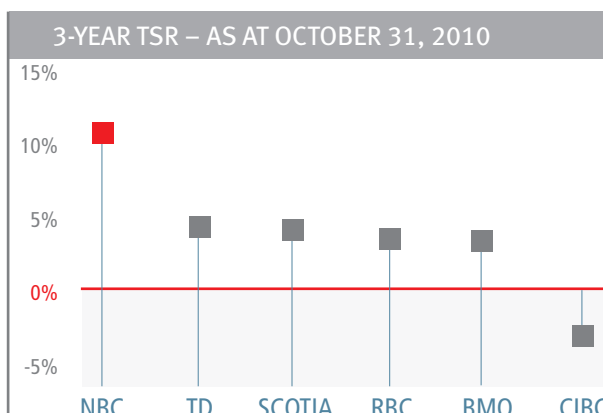
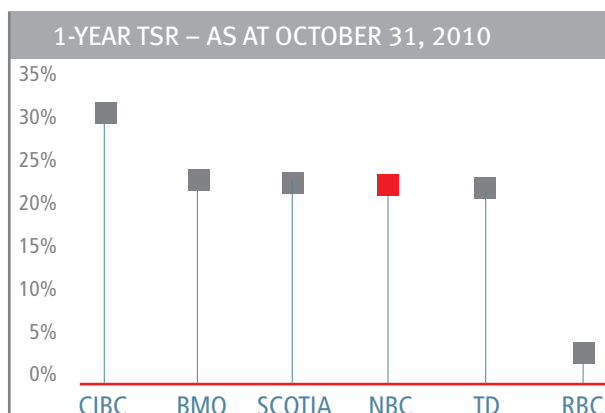
A SIGNIFICANT CONTRIBUTION BY THE PRESIDENT AND CHIEF EXECUTIVE OFFICER TO THE BANK'S PROFITABILITY

In 2010, the Bank increased its net income by 21%, reaching a record level, and maintained the quality of its credit portfolio, as well as a solid Tier 1 capital level and liquidity profile, despite the uncertainty relating to the global financial system.

The relative return of the Bank's share (TSX: NA) was also the best among the major Canadian banking institutions (see graph at right). Over the previous three years, this return exceeded that of the Canadian market as well as those of various indexes consisting of foreign banking institutions.



Also, in 2010, the Bank's total shareholder return (TSR) compared favourably to the five other major Canadian banks and was significantly higher over the past three years as shown in the charts below.



Therefore, since 2007, despite the major challenges related to ABCP and the difficult economic situation in 2009, the Bank's financial performance has sustainably grown under Mr. Vachon's leadership. The table below illustrates the change in the Bank's financial results as well as Mr. Vachon's total direct compensation over the past four fiscal years, since he was appointed as President and Chief Executive Officer on June 1, 2007.

RESULTS	FINANCIAL PERFORMANCE			
	2010	2009	2008	2007
Net income available to common shareholders	\$971 M	\$795 M	\$744 M	\$520 M
Return on common shareholders' equity	17.0%	15.6%	16.4%	11.5%
Diluted earnings per common share	\$5.94	\$4.94	\$4.67	\$3.22
Tier 1 capital ratio as per BIS Basel II	14.0%	10.7%	9.4%	— ⁽¹⁾
Share price as at October 31	\$67.13	\$56.39	\$45.21	\$54.65
Total shareholder return (TSR)	23%	32%	-13%	-7%
Total direct compensation of the President and Chief Executive Officer	\$5.2 M	\$5.6 M	\$4.7 M	\$3.9 M

⁽¹⁾ (1) Ratios calculated in accordance with BIS Basel I in 2007.

COMPENSATION OF THE PRESIDENT AND CHIEF EXECUTIVE OFFICER

The compensation of Louis Vachon, President and Chief Executive Officer, is based on the extent to which he achieves the quantitative and qualitative performance objectives that the Board approves at the beginning of the fiscal year.

In 2010, despite the record levels of certain financial results, the situation on financial markets, the ABCP impact, and the substantial investments required as part of the *One client, one bank* transformation limited the Bank's capacity to meet its short-term financial objective for establishing Mr. Vachon's annual bonus.

Nevertheless, the Board is of the opinion that the initiatives and strategies implemented as part of the *One client, one bank* transformation are generating tangible results in the short term and favouring the Bank's growth in the medium term, thereby ensuring its long-term sustainability. The Board is very satisfied with the progress made by Mr. Vachon and his team in 2010.

Therefore, the Board, on the recommendation of the Committee, increased Mr. Vachon's base salary by 2.25% to \$869,125 effective August 30, 2010. Moreover, in order to recognize the progress made with regard to the strategic objectives for fiscal 2010, the Committee recommended to the Board that it approve a discretionary increase to the annual bonus awarded. Consequently, the Board approved the following compensation:

The Board is very satisfied with the progress made by Mr. Vachon and his team in 2010.

	TARGET VARIABLE COMPENSATION		VARIABLE COMPENSATION AWARDED
	% OF SALARY	\$	
Annual bonus (short term)	125%	\$1,086,400	\$884,000
Mid-term compensation	150%	\$1,303,700	\$1,303,700
Long-term compensation	250%	\$2,172,800	\$2,172,800
Total		\$4,562,900	\$4,360,500

The table below summarizes the calculation of the annual bonus:

BASE SALARY	X	% OF SALARY	X	% OF RESULTS ACHIEVED	=	AMOUNT
\$869,125	X	125%	X	66.66%	=	\$724,000
Discretionary adjustment approved by the Board						
\$869,125	X	125%	X	15%	=	\$160,000
Total						\$884,000

Mr. Vachon's total direct compensation (i.e., base salary plus variable compensation) was \$5,211,486, representing 93% of his total direct compensation for 2009.

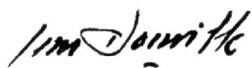
The Board requires that the President and Chief Executive Officer hold a minimum total share value equivalent to five times his average base salary for the previous three years. At the end of fiscal 2010, the total value of Mr. Vachon's shareholdings represented more than 20 times his base salary.

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 30, 2011.

The Board has full confidence in the future of the Bank and the members of management. The Bank is built on a solid foundation and has a clear and focused strategy. It has demonstrated continued vigilance with regard to risk management and the stringent implementation of strategies. Management and the more than 18,000 employees form a competent and devoted team that deploys all the efforts needed to ensure the Bank's success and longevity.

Chairman of the Board of Directors



Jean Douville

Chair of the Human Resources Committee



Jean Gaulin