

Beyond the Basics Financial Services Forum

2014 Takeaways

- **Overview** – This week we hosted our 2014 Beyond the Basics conference, where we brought together thought leaders on the key issues confronting the financial services industry including capital markets, regulatory reform, asset liability management, OTC derivative reform, capital planning and, housing finance and retail banking. In our note, we lay out the key insights from each of the sessions which go far beyond the bullets we lay out below.
- **OLA (or GLAC in FSB parlance) likely to be key regulatory issue in 2014** – Regulatory issues again were a key theme at the conference. One of the larger issues outstanding for the banks is OLA (note that Wells estimated at its analyst day that OLA could be in a range of 18-24% of RWA), and our regulatory expert noted that we may see the FSB submit an initial draft proposal on an international standard as early as Nov '14. WFC and BAC seemed confident with their ability to comply with the NSFR rules given less onerous impacts on traditional banking models with strong loan to deposit ratios. One of our speakers suggested that the Fed believed that NSFR was somewhat overly onerous on treatment of repo and may want to soften the rules.
- **CCAR process** – The Fed will likely continue to focus on CRE losses in next year's stress test and one of our speakers familiar with the Fed process noted that the assumed CRE price decline may increase to 40-50%, which would be a negative for banks with large CRE exposure (ie ZION). Although multiple pieces of regulation and the CCAR process involves banks over \$50 billion, one speaker suggested that the most stringent line is around the 8 largest SIFI banks and that they need to rank above the median of the 30 banks or face increased risk of qualitative failure. BAC noted that CCAR has led to increased emphasis on cleaning up delinquent loan portfolios due to the high loss assumptions in the stressed scenario.
- **Bank M&A door open for institutions at the \$100 billion range** – One of the more surprising takeaways from the panels was that the door for transformative M&A for banks in the \$80 billion to \$150 billion range is not closed. One speaker went as far as to say that we could see a deal by the end of '15.
- **Loan spread compression is decelerating and banks do not seem to be modeling in large outflows for DDA** – In our meeting with Paul Ackerman from WFC, he note that the recent loan spread compression has abated somewhat over the past couple months, but it is too early to tell if this is a temporary phenomenon or a sustainable trend. Also, both JPM and WFC noted that they do not believe there will be significant DDA outflow in a higher rate environment.
- **GSE reform likely stalled until after elections** – GSE reform continues to move slowly and progress has likely stalled until the mid-term elections are over, as the administration / Treasury seems to have backed off for now due to the divided 13-9 committee vote on the Johnson-Crapo bill.
- **SEF adoption relatively smooth, but future uncertainty remains** – Both GS & our industry expert noted that the transition to mandatory SEF trading has been relatively smooth with RFQ style trading remaining the dominant way of doing business, and that that the transition to SEFs was not a driver of recent FICC weakness. However, both participants noted the SEF transition is in early stages and there is uncertainty with how this shift may ultimately impact the revenue pool especially if more swap trading moves to lower margin futures.

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Asset Liability Management – Wells Fargo

We had Paul Ackerman, Treasurer at WFC and Ethan Heisler, Bank Treasury Strategist for Fixed Income Trading at Citi address topics on asset liability management, how recent regulation may have impacted thinking on asset liability management and operating in the current low interest rate environment.

- **Loan spread compression has abated in last few months** – WFC mentioned that loan spread compression has decelerated in the last few months however it is too early to tell if this is a temporary phenomenon or a sustainable trend. Loan spreads have compressed significantly for both consumer and commercial loan categories over the last few years. Consumer loans have seen steeper drops in loan spreads especially in auto while C&I spread declines have been more of a “grind down”.
- **Liquidity rules are manageable; NSFR less of an issue than LCR** – WFC believes they are relatively well positioned on the NSFR as this ratio is more stringent on capital markets businesses than traditional banking businesses. While WFC believes the LCR is manageable, it does view some aspect of the proposed calculation as too onerous. Firstly, WFC believes there should be a distinction between the treatment of liquidity lines of credit and operating lines of credit. In the bank’s experience, under a tough economic backdrop, customers usually draw on liquidity lines, but hardly ever draw on operating lines (for example, legacy Wachovia only saw a 1-2% draw on its operational lines). WFC also hopes that the treatment of collateralized municipal deposits will become more favorable.
- **Wells not very concerned that LCR will lead to higher deposit betas** – During its investor day, WFC disclosed that deposit betas on its interest bearing deposits could be ~40-50% for a 100 bp parallel shift assuming a mostly static balance sheet. Given that retail deposits are assigned more value under the LCR, many investors believe commercial banks may be incented to pay a premium to retail customers to attract better quality deposits. While he agreed with the premise, we do not get the impression that Wells is factoring in significantly higher betas than prior cycles due to the assumption that consumers place a higher value on Wells broader product set.
- **Wells Fargo’s hedging strategy for MSR seems a bit different than peers, and we believe MSR hedge gains are part of core earnings for Wells as it is mainly carry income** – Unlike other banks which include MSR hedging as part of their overall treasury function, and hedged out with swaps and options, WFC hedges within the mortgage business using primarily TBAs. The TBAs have a higher yield over swaps, and thus accrues to Wells bottom line along with it can be viewed as having less basis risk. Offsetting the positive carry, Wells protects against the tails using options...but in a low vol world, this protection cost is lower...so the current steep yield curve and low volatility environment should garner continued gains.

The way we think about it is while WFC balance sheet is very asset sensitive as shown at its recent analyst day, part of this is being monetized via this hedging strategy and thus we believe the MSR gains should be viewed as core earnings as net interest revenue is depressed due to the asset sensitive nature of balance sheet.

Auto Finance – Santander Consumer

We had Santander Consumer President & CFO Jason Kulas present on Auto Finance. Similar to the Q1 earnings call, Kulas highlighted a mixed bag of pluses and minuses, yet maintained expectations for 10%+ earnings growth.

- **Color on Credit** – On credit, some further clarity was provided on the larger loan loss provision in Q1. About a 1/3rd of y/y growth in the provision was self-imposed and driven by some loans originated at new Chrysler dealerships where behavior did not play out as they assumed, meaning full procedures were not followed. SC had given these new dealerships the benefit of the doubt given the Chrysler Capital relationship, yet has now put in procedures to rectify the situation.
- **Used Car Pricing Holding Up** – At this point SC feels their reserve (11% of the portfolio) is sufficient to protect from the softening subprime auto environment. While they are underwriting new loans with an assumption that recoveries (i.e. used car prices) decline from current mid-50% levels, they cannot rule out the Manheim index holding up better than expected over the next 12-months given recent strength. We do expect modest volatility in the quarterly provision given the nature of SC's business and reserving policies.
- **Well- Positioned for Potential Regulatory Inquiries** – We felt comfortable with mgt's approach around regulatory risk (i.e. CFPB) as SC implemented a fair lending system several years ago at the direction of Banco Santander. So they are arguably in a better position versus their sub-prime lending peers and we did not sense any specific issue brewing. Mgmt also believes that should a more draconian "flat" dealer mark-up be implemented in the industry, they would manage through fine. Our discussion with industry auto execs suggest that dealers would make up some of this lost revenue by additional fees.
- **Funding Markets Remain Stable** – Mgt remains confident that the Chrysler penetration rates will be hit. Interestingly, they are seeing record demand from financial institutions and ABS markets for the loans that SC originates then sells.
- **Industry Read-Throughs** – Based on this meeting and other industry discussions, we sense that peer ALLY has gotten more active on higher yielding (further down the credit spectrum) auto loans since their IPO. SC is still seeing steady industry competition from not only private equity backed subprime auto lenders but also credit unions and com.

Capital Planning – Bank of America

Bank of America CFO Bruce Thompson and new CRO Geoff Greener were with us to discuss capital planning. BAC outlined their approach to capital allocation, how the various capital ratios have impacted their allocation process, and how recent stress tests results are impacting their thinking around leverage and preferred stock.

- **Next wave beyond New BAC 2 cost initiative, BAC looking for ways to make the business simpler and easier to manage** – Greener noted that the goal is to make capital management as simple as possible for the various business lines so the managers can focus on running their businesses. BAC is also looking to simplify the business as a way to drive cost savings. Most of this progress has been seen through the LAS expense save initiatives and new BAC. However, BAC has also recently spoken to a new Simplify and Improve program to look for additional expense saves beyond new BAC.
- **Comments seem to imply upside on LAS cost savings targets** – Thompson noted that BAC continues to work on bringing down Legacy Asset Servicing costs, reducing the size of the delinquent loan portfolio and getting from \$1.6 bil in core LAS costs down to \$1.1 bil by the end of 4Q14. Thompson noted that longer-term BAC would like to have a cost of servicing loans that is inline with the industry average, which leads us to believe that BAC could reduce core LAS costs below \$500 mil/quarter, based on delinquent loans of 200-250k/year and an industry cost of servicing a delinquent loan of ~\$3,000/year.
- **CCAR providing an incentive to accelerate clean-up of the balance sheet** – Thompson noted that while BAC feels good about the current capital position, CCAR has increased the emphasis on cleaning up the delinquent loans due to the high loss assumptions in the stressed scenarios and accelerated the pace at which they are looking to move these loans off of the balance sheet.
- **A thoughtful approach on capital allocation** – The goal is to push all of the capital out to the business lines and to where it earns the right returns. We think BAC takes a thoughtful approach to setting capital targets, considering what the capital target would be for competitors to that business, including a SIFI buffer.
 - **Larger RWA mitigation opportunities seem to be in rear view mirror** – Thompson noted that while there may still be some smaller opportunities on the margin, most of the RWA mitigation is in the past as they've finished reducing the larger securitization positions with higher risk weightings. Additional opportunities from here will be in derivatives trade compression and the move to central clearing.
- **BAC discovered the \$4 billion capital adjustment while creating enhanced disclosure for its 10Q** – BAC noted the adjustment related to the MER structured notes that resulted in the suspension of their capital plan was found during the process of creating enhanced disclosure in the 10-Q around the structured note positions. BAC noted that within 24 hours of discovery the need for an adjustment was reported to both management and the Board of Directors.

In our session on Regulatory developments, Pat Parkinson from Promontory Financial Group noted that BAC's self-reporting of the adjustment in a timely fashion is an important factor for investors to think thru when trying to assess whether this would have any impact going forward for BAC.

Capital Markets – Goldman Sachs

Harvey Schwartz, CFO of Goldman Sachs, and Marty Chavez, CIO of Goldman Sachs, spoke on their capital markets outlook as well as the role technology plays in today's market structure.

- **GS views its singular technology platform as a competitive advantage** – GS believes technology is a competitive advantage for the firm because it is integrated into the front office and down into the businesses rather than relegated into a secondary support role. Also GS noted that it is competing for the best engineering talent with firms like Google, and we followed up with other technology people outside of GS who confirmed that GS is one of the few financial firms able to do this because of its strong brand recognition.
- **GS can extend this integrated tech platform to clients** – Through this platform, GS is not only able to better manage their own risk and client risk, but also better manage client 'workflow.' By integrating pre/post-trade analysis, inventory analysis, trade handling, execution, etc for clients, GS is better able to capture revenue throughout the trade cycle. This multi-faceted single platform integrates front, middle and back office functions for clients and for themselves, increasing efficiencies for clients. GS points to their Equities business as an example, where they were not just selling a stock, but also a platform. Technology makes up 25% of the workforce at GS.
- **FICC weakness more cyclical than structural** –Harvey Schwartz noted that outside of higher capital levels, there have not been any game-changing regulations that have driven significant structural changes...and he remains in the camp of it being more cyclical than secular. As a contrast, he noted that the secular change in the equity market structure was influenced by 3 major regulations: 1) Reg NMS 2) Reg ATS and 3) Decimalization.
- **GS believes that long term, Europe may become one of its fastest growing markets** – GS feels that EU may become one of the fastest growing markets due to: 1) the desire for clients to become less bank dependent will lead to the evolution of the EU capital markets; 2) given the tough economic environment, clients appreciate and need more advice; and 3) the competitive dynamic given the challenges facing the EU banks, GS sees pockets of opportunity.
- **Dark pools are not material for GS; no strategic plans for Sigma X** – Contrary to recent press reports, GS has no strategic plans for their dark pool, Sigma X. While future regulation around dark pools is uncertain, GS noted that Sigma X is not material for GS. Sigma X is just one of many execution platforms GS can offer clients. GS reiterated their support for greater focus on the market's plumbing and infrastructure which needs to keep up with the technology and speed of the markets.
- **Hard to identify what is driving current low volatility, but GS is well positioned for increased activity levels** – While Harvey noted that higher vol markets are easier to explain than low vol markets, he did try to lay out a case on why the current low vols make some sense due to increased liquidity & bank capital, quantitative easing, etc. He noted it's a challenging environment, and that the best position for GS to take is to remain disciplined on cost and position the firm for significant operating leverage when the environment eventually improves.

Commercial Real Estate

KC Conway from Colliers and Brian Olasov from McKenna Long and Aldridge discusses their outlook on Commercial Real Estate and the CMBS market.

- **Stress test for commercial real estate likely to increase** – In the 2013 Stress Test, the Fed stressed commercial real estate values by 20%; in the 2014 stress test the Fed stressed CRE by 30%, but there has been conversation that this number is likely going higher to ~40-50% given the Fed's concern about real estate values and overbuilding. Our panelists noted that historically, there has been a 25% probability of default with a 50% loss severity, resulting in losses of 12.5% on the original principle balance. This is far lower than the rates the Fed is currently proposing in their Stress Tests. This is could be problematic for banks with high CRE exposure such as ZION.
- **Overbuilding is not an issue in the commercial real estate market** – Our panelists did not believe the US is overbuilding in the CRE sector. While there has been some strong building growth in select markets, this is largely in areas where strong GDP growth has supported industry expansion, particularly in manufacturing. Manufacturing has had a significant resurgence given favorable exchange rates and cheap energy which will likely continue to influence the demand for housing and commercial real estate in the future.
- **Large CRE refinancing wave due over the next 3-4 years** – The large CRE refi wave may see some hiccups given the reduced willingness by banks to refinance these loans due to increased scrutiny from the regulators on CRE lending (ie higher loss rates in Stress Test scenario). In the past, some of this capacity was absorbed by the CMBS market, but there is now increased competition for Fixed Income investment dollars (ie HY, LBO debt). This refinancing wave is also coming at a time when underwriting standards are declining and cap rates may be rising due to a likely rise in interest rates which would also lead to higher debt service ratios. The sectors with the highest level of refinancing are the office, retail and multi-family sectors. A potential offset to these problems is the foreign demand for higher yielding products.

Consumer Banking – JP Morgan

David Owen, JPM's CFO of Consumer and Community Banking, was with us to discuss JPM's CCB expense reduction initiatives, retail branch optimization, and other trends in consumer banking.

- **JPM's \$2 bil expense initiative includes 50% in mortgage & 50% in CCB ex mortgage** – JPM has pushed down its expense reduction goals into the CCB businesses and progress is reviewed every month with CCB CEO Gordon Smith. Low hanging fruit opportunities include simple, non-tech intensive expense reductions such as optimizing the hundreds of millions of dollars spent on things like paper and postage and employee training expenses. The majority of JPM's expense initiative lies in addressing the two-thirds of expenses related to headcount, which requires rolling out more branch automation (eg Teller Cash Recyclers) and customer self-service tools (eg Electronic Banking Kiosks).
- **JPM has a rigorous process to evaluate branch openings and closings** – Now that JPM has in-filled the legacy WaMu footprint in CA and FL, the company is targeting net zero branch openings going forward. JPM's branch planning process starts with a breakdown of the entire country into 50 million quarter-mile squares. Then there are 400 data variables overlaid onto each square, including demographics, traffic, customer behavior, affluence, etc. This outputs where there are opportunities to open new branches or consolidate. Next, JPM drills down further into 2,300 micro-markets to find additional consolidation opportunities where branches may overlap. Each branch is assigned a retention index which indicates the extent to which JPM wants to keep vs close the branch. David also highlighted that its branch prototype used to be ~5,300 sq. ft. and now the vast majority of new builds are <4k sq. ft.
 - **Revenues are the biggest difference between profitable vs unprofitable branches** – In terms of profitability differences between branches, David explained that there is not much variability in expenses so the biggest difference lies in revenues, which is primarily affected by differences in the level of deposit balances. David highlighted that nearly all of JPM's mature branches (ie open 10+ years) are profitable and the ones that aren't get flagged for additional comprehensive review. He also emphasized that over the last couple of years, JPM has aggressively rolled out Chase Private Client to deepen relationships and wallet share among its mass affluent clientele.
 - **CFPB may revisit overdraft fees later this year** – David noted that the CFPB has been amassing a ton of data on bank overdraft fees and he thinks it's possible there may be an update later this year or early next year.
- **JPM doesn't expect a lot of DDA runoff when rates rise** – While David agreed that the ease of deposit transferability has increased over time due to the rise of online and mobile banking, he does not foresee significant DDA runoff when rates rise.
- **JPM compares best practices in retail banking against a broad swath of competitors** – JPM compares and evaluates best-practices in its retail banking franchise against bank competitors such as Santander and companies in other industries such as USAA. David gave an example where USAA was the first to roll out a mobile check image capture technology and JPM emulated this capability to become the first large branch bank to offer it.

European Bank Outlook - UBS

Tom Naratil, CFO of UBS spoke about the progress UBS has made in capital generation, the ongoing wind down of legacy and non-core portfolios and the outlook for capital return in the face of a large number of regulatory headwinds. Overall, the tone of the meeting was positive and Tom emphasized the strong core business of wealth management, and the success that UBS has had in winding down its non-core businesses.

- **Strong progress on capital generation and resolvability** – Naratil highlighted UBS's strong capital position, having exceeded their 13% CET1 target close to the 10% stressed CET1 ratio. The sale of a structured credit portfolio should drive a further 30bps CET1 ratio benefit in 1Q14. He also highlighted a number of steps UBS has taken to address resolvability concerns including the implementation of a single holding company structure, with distinct legal entities in Switzerland, the UK and US, and. UBS expects these actions to result in a capital rebate under Swiss regulations.
- **Industry litigation is likely long-tailed** – Naratil reiterated that legacy litigation and regulatory exposures are the largest risk to the banking industry and that resolution may be long tailed.
- **Regulatory burdens are hurting credit availability in balance sheet intensive LOBs** – Naratil said banks are feeling the largest effect in balance sheet intensive product lines like mortgage, highlighting a key difference between the European and US market where agency securitization alleviates some of the SLR's pressure on credit availability. Other regulatory risks include: operational risk, stress-tests (eg CCAR), subsidiarisation requirements and greater industry scrutiny on interest rate risks.
- **Acquisitions not likely near-term** – UBS' strategy for M&A is based on total absorption where targets are fully integrated under the UBS brand. The strategic plan is based on organic growth although fill-in acquisitions cannot be ruled out in certain products and markets.
- **50% Payout likely conservative** – UBS strong capital generation ability raises the question of whether a 50% payout ratio is conservative. Tom stressed that UBS needs to demonstrate its ability to return 50% of earnings first and emphasized that they are very comfortable with their stated target.

Housing Finance Reform – Redwood Trust

We met with Redwood Trust CEO Martin Hughes and IR Mike McMahon to discuss outlook on GSE reform and private label securitization and other key topics on US housing finance.

- **Progress on GSE reform likely on hold until next year** – Martin described the Johnson-Crapo bill as “on the ropes” due to its divided 13-9 committee vote last week. Importantly, the Democratic vote was split 50/50, which means Senate Majority Leader Harry Reid likely won’t bring the bill to the broader Dem-controlled Senate in its current state. Martin expects the bill to be pushed out until the next Congress, which means the upcoming midterm elections will be crucial in shaping the direction of the bill. Democrats want more affordable housing initiatives and more favorable provisions for community banks, while Republicans want as little govt involvement as possible. At a high level, Martin believes reform is still ~5-7 years away.
- **Credit risk sharing deals will continue to evolve** – Martin believes GSE credit risk sharing will ultimately take on multiple forms. MI is not an optimal solution because the industry nearly failed during the crisis and the FHFA doesn’t want to rely too heavily on that industry in Martin’s view. In the STACR/CAS deals, the GSEs retained first-loss risk to make the mechanics of the structure easier to implement, but over time they will find a way to sell off the first-loss risk. Martin believes one possible option is for the GSEs to reduce a seller’s g-fee in exchange for bearing first-loss risk. This would enhance the value of the pools because the sellers are directly on the hook for losses. He also believes bigger players like Swiss Re or Berkshire Hathaway will enter the market in a reinsurance capacity.
- **Limited PLS momentum is due to lack of liquidity and best practices** – Martin believes that lack of liquidity is the biggest reason for the limited private label activity today. On the issuer side, banks are sitting on trillions of dollars in liquidity and are simply holding mortgages yielding 4.5-5% on their balance sheets, so there’s no economic incentive for them to sell/securitize. On the investor side, the market has not recovered enough for major institutional investors to allocate staff and resources to the product, and the swath of investors that were burned during the crisis are still boycotting the product due to lack of best practices, ie reps and warrants, safer structures, better behavior from servicers, etc.
- **Second mortgages are an overlooked risk to the industry** – Martin strongly believes that second mortgages should be more tightly regulated because they result in a significant change to the credit risk profile of a borrower, yet they often get ignored. For example, second mortgages are not accounted for in the QM rule’s 43% DTI calculation. Second mortgages also create misaligned incentives when a servicer owns the second mortgage, but services the first lien.
- **Housing market is fairly valued; fading investor bid, higher mtge rates, and QM are potential risks** – Martin believes housing is fairly valued today but confidence in the market was buoyed by private equity investors, which raises questions on what happens when they exit. Also, first-time homebuyers historically traded up on their homes after ~5 years but they may not do this when rates rise given that their first purchase was at generationally low mortgage rates. He is also unclear on how the ~20% of the market comprised of non-QM borrowers will get financing given the litigation risk.

Mobile Payments

Greg Baxter, Citi's Head of Global Digital Strategy spoke about the trends in digitization and mobile payment. The global shift to digital banking/payments presents both risk and opportunity for large banks. There will clearly be lost revenue overall as fees rates compress, but the effect can be offset with expense efficiencies.

- **Efforts to improve mobile payment security could drive adoption** – Baxter highlighted the need to move away from exchanging card information directly as the exchange of card data across a range of payment channels creates significant security concerns if one channel is compromised. Baxter argued that the move towards tokenization, whereby each device is given unique public payment credentials lessens the risk and will help reduce fraud for online payments. The Target breach has clearly accelerated the planned adoption of EMV Chip which should reduce fraud in the US.
- **Near-term threat to card networks is low** – Despite a lot of emerging payments technologies, Visa and MasterCard face minimal disintermediation in the near-to-intermediate term. PayPal continues to find it challenging to enter the physical point of sale, and in fact may be reaching out to banks to build relationships. However, Baxter highlighted that channels like Paypal may drive credit transactions into debit and ACH transactions on the margin. Ultimately, Baxter emphasized that successful payment channels will need to adapt to span both the digital and physical channels in order to capture significant market share.
- **Mobile payment focus is on advertising wallet** – Baxter sees the valuations for mobile payment platforms like Square as driven more by the advertising wallet share and services they can provide rather than the payment margins.
- **A digital wallet via MasterCard's MasterPass will be rolled out in the next few months** – MasterPass branded on the website checkout, then the consumer sees the bank name displayed after entering.

We also hosted Ramneek Gupta, Venture Leader at Citi Ventures, a global venture capital arm of Citigroup focusing on next generation financial services technology, commerce and payments, big data/infrastructure, and security. Ramneek spoke about his views on what drives successful adoption of mobile payment systems and the key themes in the payments space to watch. Other topics included the potential shift towards real-time debit and ACH transactions in the mobile payment space, and the potential for large tech players like Apple and Amazon to emerge as mobile payment leaders.

- **Successful mobile payments apps must improve payment experience, data and/or access** – Gupta laid out his 3-part view of what drives successful adoption of a mobile payment solution. A successful mobile payment platform does not offer an attractive value proposition without improving on one or more of 1) Experience – making manual processes automated and seamless 2) Data – giving retailers access to better customer data or 3) Access – making digital payments possible in a previously inaccessible market.
- **Move to real time ACH could accelerate mobile adoption** – Gupta sees a tradeoff between consumer and merchant cost and convenience in the current payment channels. While ACH is more affordable for merchants, it is less convenient for consumers. Card-based rails offer customer convenience, though carry higher merchant costs. Gupta highlighted that if ACH modernization does

eventually move to real-time, debit/ ACH could become the dominant mobile payment platform. This would result in convenience for consumers and a lower-cost alternative for merchants, which could help drive adoption. Real time ACH would benefit PayPal as well.

- **Little chance of total disintermediation, despite a switch to lower margin transactions** – Despite Gupta's view that mobile payment adoption will drive lower margin transactions, there is a relatively small chance that current payment rails will be disintermediated. The majority of mobile payment methods still run on the traditional channels, and the substantial consumer and business demand for credit products in both mobile and non-mobile settings will likely stem a decline in credit transactions.
- **Location based “beacons” will likely contribute to mobile payment adoption** – The conventional wisdom is that digital wallets have a higher capacity for multiple payment options and expand consumers' payment opportunity set. Gupta argued that the proliferation of multiple payment platforms can present challenges for consumers to quickly select from the multitude of apps and payment methods at their disposal. Gupta believes this can be remedied by location-based (e.g. Bluetooth or NFC) “beacons” and application aggregators (e.g. Apple's Passbook) that “orchestrate” the selection of appropriate payment methods and reduce the effort required to adopt and use new payment methods.

OTC Derivatives Reform

Chris Perkins, Head of Collateral & Clearing at Citi, spoke on the outlook for OTC Derivatives reform including what is left on the regulatory front and opportunities in the investor services space.

- **SEF has been a relatively smooth transition...** – Chris noted that the onboarding of made-available-to-trade (MAT) swaps onto SEFs went relatively smoothly for the industry participants. From a market perspective, mandatory trading on SEFs has been a non-event and the lull in volumes isn't a result of newly required trading rules, but instead cyclical given macro uncertainty and client aversion to risk. Chris noted that in the swaps market, technology is behind regulation which is why it has taken time to realize some efficiencies and get a true understanding of client behavior.
- **...With SEF trading remaining status-quo for the time being** – Post mandatory SEF trading, almost all trading is still done request-for-quote (RFQ) and Chris expects this style of execution to remain for the foreseeable future. The SEF market has not seen the emergence of the central limit order book (CLOB) style trading that was predicted. Clients, like large hedge funds or asset managers, still prefer RFQ style trading because buy-side clients have incentives to let sell-side know that they are trading with them to leverage relationship for better pricing. Bloomberg and Tradeweb have been the dominant D2C market SEFs, while ICAP and GFI have captured most of the interdealer flow. Chris also noted that there has not been a significant shift towards trading futures, or 'futurization', given the lack of customization and the fact that the market has not seen significant collateral requirement pressure.
 - **GS also commented that SEFs have continued to trade RFQ** – GS also noted that the SEF transition has been relatively smooth for the market and that execution style remains RFQ. GS noted that their top concern is on the emerging market structure for swaps/SEFs; the SEF market should build off lessons learned from the equity markets that having different rules for different players can create market instability. GS noted that the move to SEFs was not a headwind, but that the full impact will take a while to evolve.
- **Collateral crunch has been lower than expected** – Initially, the estimates for additional capital and liquidity to meet margin requirements due to mandatory clearing rules for OTC derivatives were as high as \$1-2 tril and would create an additional burden for both clients and broker-dealers. Chris noted that so far this number is only ~\$30 bil. This number is set to grow in the future due to 1) large derivative positions are just being rolled off – not backloaded so don't require the margin; 2) Europe has not come on yet and; and 3) non-cleared rules have not been finalized. Chris expects this number to ramp up significantly as these changes take place, but to remain below the initial estimates.
- **Industry remains focused on being compliant, not expanding or differentiating their business** – Chris noted that so far the industry has been focused on being regulatory compliant and building out the necessary technology platforms to achieve this. The industry has not been focused on ways to grow and innovate their business models. This is starting to change which is why there has been some consolidation in the clearing players (ie RBS has just exited) and SEF consolidation. Chris expects participants to begin to differentiate in pricing, offerings, and innovative technologies like in the collateral transformation business.

Outlook for Bank M&A and Capital Deployment

Jamie Gregory Head of Corporate Development and Planning at Regions, Todd Baker EVP of Corporate Strategy and Development at MUFG Union Bank and a Citi expert discussed the outlook, potential for and hurdles to complete bank M&A.

- **There is increasing dialogue around bank M&A, but the regulatory process remains a hurdle** – Our panelists noted that there has been increasing dialogue in the banking industry around M&A in the last 6-8 months, however, obstacles to potential deals remain. Most notably, the regulatory process is now much tougher, including increased scrutiny (for example, the delays in the MTB-HCBK deal over BSA/AML compliance), and the need to submit pro forma stress tests results on the combined entity. While the tougher process does affect IRR hurdles for deals, banks are getting better at understanding and dealing with the process, which could lead to more deals going forward. Banks remain acquisition-ready, but will also need to be picky as they will be limited in the number of applications they can submit to the Fed and any small error could impact a bank's ability to do deals going forward.
- **There is potential for transformative deals, but the days of serial acquiring are likely over** – Our panelists believed there remains potential for transformative deals going forward, even among banks with \$80-150 bil in assets. While there is pressure to prevent banks from being too big to fail, there is an argument to be made that more super-regional banks the size of a PNC or USB may not necessarily be a bad thing for the industry and bank customers, to prevent a sort of “bank oligopoly”. However, there will be some desire on the side of regulators to see a bank finish a deal and successfully integrate a target before moving on to another potential deal, which will prevent banks from growing through streaks of quick, successive acquisitions.
- **The returns from an acquisition of some deposit types look low in the current environment, but strategically could be very attractive** – Given the low rate environment that currently exists, returns from acquiring deposits do not look all that attractive. However, given the value that retail deposits in particular have under new liquidity rules such as the LCR, and the fact that low interest rates reduce the price of deposits, the strategic value of deposits is higher than it has ever been.

Private Label Credit Cards

We had Bill Johnson, CEO of Citi Retail Services discuss trends in private label credit cards.

- **Private label cards is a relationship business with barriers to entry and high returns** – Over the cycle, private label has equal to if not potentially higher ROA's than general bank cards.
- **The business remains competitive with newer participants getting active such as Wells Fargo and TD** – Though the sector has a history of new players ultimately exiting as they under-estimate the skill sets required versus typical card lending. A good private label issuer views themselves as a partner of the retailer, to help drive more sales.
- **The outlook for private label growth is solid with plenty of potential deals over the next several years** – And retailers look to private label as a way to grow sales. Private label card penetration for retailers can range from 7-8% on the low end to 60-70% on the high end, averaging 20%+.
- **Portfolio sales today are often done at "par", meaning no premium on the receivables** – Rather the retailer gets the economics through income sharing over time, particularly as retailers are healthier and often don't need the upfront cash premium.
- **Nordstrom and Cabela's are two of the last remaining in-house funded card portfolios, and news reports suggest Nordstrom is selling their portfolio** – Separate from this meeting, other industry contacts and news reports have suggested potential buyers include Capital One, TD Bank, Citi and JP Morgan. Wells Fargo has been a very small player historically but more recently won the Dillard's portfolio.
- **Despite perception, private label is not just subprime** – Rather it is a mix across the broad credit spectrum. Despite recent market fears that the subprime consumer is weakening, we did not sense this was the case in private label today.
- **The CFPB is focusing on deferred interest for the private label segment, yet seems mostly focused on making sure consumers get the proper disclosures** – Deferred interest is where there's an initial 0% teaser rate for a period of time, but interest is charged retroactively back to inception if the balance is not paid off at the teaser expiration.
- **Private label cards are often cited as a potential beneficiary of mobile payments, as consumers won't have to carry numerous plastic cards in their wallet** – However, the presenter played this down as most retailers don't require the card to be present, as it can be authenticated verbally via phone number, etc. Separately, digital expertise is increasingly a differentiating factor among issuers when bidding on new deals.
- **Private label often has data sharing with the retailer, including SKU level data** – The level of data tends to increase with time and trust. Having a large general bank card business is an advantage as it is another source of data to leverage, to help a retailer drive sales via offers, etc.

Regulatory Outlook

- **Political pressure on the banks is abating on the margin** – There has been some reduction recently in the pressure on politicians from the general public for increased regulation on the banks, although in general there is still a lot of pressure. Recent statistics have shown that public trust in US banks is increasing, albeit off of a low base. Per Edelman Trust Barometer, trust in financial services has increased to 50% in 2014 from 43% in 2013. As the calls for reform from their constituents have lessened, politicians have dialed back on some of the rhetoric around banking regulation. This could result in legislation to regulate the banks being pushed out past mid-term elections and into 2015 or 2016.
- **A potential bank tax is at the forefront of potential legislation** – This year, a bank tax was proposed by Representative Dave Camp as part of a bill introduced regarding corporate tax reform. While a tax on banks has been proposed in the past (a tax was part of prior Obama budget proposals used to offset TARP), this is the first time it is a Republican-endorsed idea. The tax would be on banks with over \$500 bil in assets and could raise an additional \$38 bil in revenue for the government (offsetting lower overall corporate tax rates). While it is uncertain if a bank tax will become law under the corporate tax reform bill, the risk is that the bank tax idea is back on the table (with some Republican support) and could end up getting used as part of any proposal. While regional / community banks are not included as part of the tax, they remain unsupportive of the bill as they fear the list of banks subject to the tax could potentially be expanded in order to raise revenue and reduce any potential budget deficits. Support for the tax may come from a Government Accountability Office study scheduled to be released in July / Sept looking at implied funding rates at large banks in the US. While the report is likely going to show large banks receive a funding advantage (subsidy), the push back will be that large banks have an elevated “cost of regulation” which offsets any benefit from the subsidy.
- **Mid-term elections will have an impact on the direction of the Senate Banking Committee and the legislative agenda going forward** – There is a lot of focus on upcoming mid-term elections, as the outcome of various Senate races will impact the leadership of the Senate Banking committee and the legislative priorities in 2015 and 2016. If the Democrats retain control Senators Schumer, Menendez, and Brown are the leading candidates to chair the committee, which could lead towards an agenda focusing on consumer protections and big bank regulation. If the Republicans are able to take control away, Senators Crapo and Shelby are the leading candidates to head the Banking committee, which could steer the agenda more towards GSE reform and modifications to Dodd-Frank legislation. The odds that Republicans could take over control of the Senate have been increasing, based on recent estimates from political analysts.
- **Expect increased dialogue around the push-out of swaps from the banking industry** – One issue that may draw some increased dialogue near-term is the potential push-out of swaps. This rule, also known as the Lincoln amendment to Dodd-Frank, would prevent banks engaging in certain derivatives activities from receiving Federal assistance, such as FDIC insurance and access to the Federal Reserve window. There has been increasing pushback from the banks and Federal Reserve Chairwoman Janet Yellen has also expressed concerns. With momentum building against the rule, there is a possibility it could be removed sometime this year.

- **GSE reform likely stalled until after elections** – GSE reform continues to move slowly and progress has likely stalled until the mid-term elections are over, as the administration / Treasury seems to have backed off for now. There are several key issues, including multifamily housing initiatives and a proposal to increase agency loan limits, that still need to get worked out before a bill can move forward. In the meantime, Mel Watt is likely to maintain an emphasis on opening the credit box to more borrowers through loosening repayment requirements. Other areas of focus for the GSEs will be reducing risk exposure through sales of illiquid assets, tripling issuance of risk sharing begun in 2013, and building a common securitization platform for Fannie and Freddie. Recent slowing of housing prices could cause members of congress to examine / reconsider some recent legislation (i.e. QM) that may have tightened mortgage requirements.

We also had Pat Parkinson from Promontory Financial Group discussed details on the stress test process and some other regulations that may be on the horizon.

- **OLA is the next significant item on the regulatory front** – Our speaker highlighted that OLA (or GLAC in FSB parlance) is likely the next significant item on the agenda for regulators. There has been no proposal on what the rule may or may not include as loss absorbing capital, how much loss absorbing capital may be needed or how the ratio may be calculated. On the calculation front, our speaker mentioned that the Fed prefers RWA as the denominator while the FDIC prefers total assets. According to our speaker, the FSB is likely to issue a draft proposal on OLA to G20 countries in November of this year.
 - **OLA is key to tackling Too Big to Fail in the US** – Under Dodd-Frank Title I legislation, regulators have the authority to research, evaluate and oversee large financial institutions so that regulators can find ways to manage risks in the stability of the US financial system. OLA (also known as Title II of Dodd-Frank) is an important component to managing financial stability as it is supposed to provide a process to efficiently liquidate an institution that may have previously been deemed Too Big to Fail. Given the importance assigned to OLA in the US, even if the FSB does not come out with an international standard for OLA, US regulators are likely to move forward on drafting a proposal, however timing is uncertain.
 - **Single Point of Entry for foreign institutions is key** – Our speaker mentioned that a single point of entry for subsidiaries of foreign institutions will be an important aspect of any potential US rule on OLA. US regulators want US subsidiaries of foreign bank entities to be sufficiently capitalized and have capital which can be ring fenced from their foreign parent.
- **Uncertainty and risk of failure in stress test continues to be centered on qualitative portion of the test** – Even though the Fed's methodology to calculate stressed PPNR and credit losses is not completely transparent to the industry and remains a source of uncertainty, our speaker expressed that the qualitative assessment continues to be the most difficult aspect of the test to manage. The bar is constantly being raised for the qualitative test and even though the language may be the same, institutions are held to higher standards from one year to the next. Importantly, our speaker mentioned that simply because an institution passes the quantitative portion of the test with a significant amount of capital above the minimum, that institution is not guaranteed to pass the qualitative test. The tests are run by different people at the Fed.

- **Qualitative test includes a central examination which can supersede the onsite local examination** – The first step of the qualitative review is for an institution to work with its “local” Fed regulators who work specifically and exclusively with that institution to implement processes and models to help satisfy the requirements under the qualitative assessment. Importantly, this is not the final word on whether a bank passes the qualitative portion of the exam. The next step is a “horizontal review” performed by a central group named the CCAR Executive Committee. The horizontal review consists of a system where the committee will rank each CCAR participant from 1-30 based on their internal processes and models. In order to pass the qualitative portion of the stress test, an institution not only needs to convince the onsite team that they should pass but needs to perform well on the horizontal review. If an onsite team believes an institution has made significant strides in its internal processes, the horizontal review can still cause the institution to fail the qualitative portion. According to our speaker, the largest 8 US SIFI banks need to rank above the median lest they face increased risk of qualitative failure.
- **The BCBS NSFR proposal may be too punitive on repo** – Although regulators have considerably scrutinized repo markets, our speaker believes that the 50% net stable funding requirement placed on repo in the BCBS NSFR proposal may be softened by US regulators.
- **Regulators may look at other ways to regulate repo market** – Regulators may take further action to curb reliance on wholesale funding. Our speaker mentioned that one option could be to adjust the G-SIFI charge higher for those banks that are more reliant on wholesale funding or have large SFT businesses.
- **The regulatory line is stricter around 8 largest SIFI banks** – Although multiple pieces of regulation and the CCAR process involves banks over \$50 billion, our speaker suggested that the most stringent line is around the 8 largest SIFI banks that may be seen as Too Big to Fail. This delineation and recent commentary from Tarullo may suggest a softer stance on banks above \$50 billion but smaller than the 8 largest SIFIs.

Appendix A-1

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