LCR Competitive Analysis Report

2015-2016 MDP Project

Prepared by: Mary Guinn, Olivia Hampton, Dave LaPergola, Jason Lee and Alex Ruff

February 3rd, 2016

Table of Contents

Report Overview **4**

Purpose: 4

Important LCR Dates: 4

Competitors Researched: 4

M&T Retail Products **5**

Overview 5

Checking Accounts: 6

Savings Account: 8

Time Deposits: 9

Loans, Credit Cards, Mortgages, and HELOC: 10

Mobile Banking: 11

Retail Product Breakdown 11

Deposit Comparison 12

M&T Regional Analysis 12

Industry Analysis 15

Hudson City 17

M&T Sales Process to benefit LCR 17

Operational Vs. Non Operational Deposits **19**

Overview: 19

Risks: 19

Industry Analysis: 19

Recommendation 20

International LCR Implementation **21**

Overview 21

Foreign Products and Solutions 21

BNP Paribas Lcr 1 (BNPLC1:FP) 21

Foreign Industry Analysis 21

Lessons for American Industry 22

Perpetually Resetting CDs 24

Overview: 24

Risks: 24

Industry Analysis: 24

Recommendation 25

Industry M&A Impact 26

Creating Industry Tiers 26

Costs of Infrastructure 26

Acquiring Deposits 26

Conclusion 27

Report Overview

Purpose:

This report covers the banking industry's response to the Liquidity Coverage Ratio (LCR) and provides recommendations based off of the industry's best practices. This report look takes into account both full LCR banks and modified LCR banks, domestically and internationally. If you are unfamiliar with the LCR regulation please refer to [reference].

Important LCR Dates:

For M&T Bank, a modified LCR bank an LCR number of 90% is required to be reported monthly starting January 2016. In January 2017, all banks must start full compliance and report LCR numbers 100% or greater.

Competitors Researched:

Below is a table of all the competitor banks used to complete this report:

Full LCR Banks ($250MM+)	Modified LCR Banks ($50MM+)
Bank of America	BB&T
Capital One	Coamerica
Citi Group	Fifth Third
JP Morgan Chase	Huntington Bancshares
PNC	Key Corp
US Bancorp	Regions Bank
Wells Fargo	Sun Trust
	Zions

M&T Retail Products

Overview

Under LCR, there is increased emphasis on obtaining more retail deposits due to their liquidity. In order for M&T to stay well over the LCR standard it is imperative for our accounts to appeal to all customers in our market. Below, we have listed M&T's current retail product offerings along with explanations of the requirements attached to each product.

We have also included the relevant results from a brief survey sent to Management trainees on the retail track asking their opinion on M&T's current product offerings, as well as suggestions on how to improve our retail products in order to make them more appealing to a larger customer base.

Below are a few charts reflecting the demographics and current behaviors of our survey respondents.

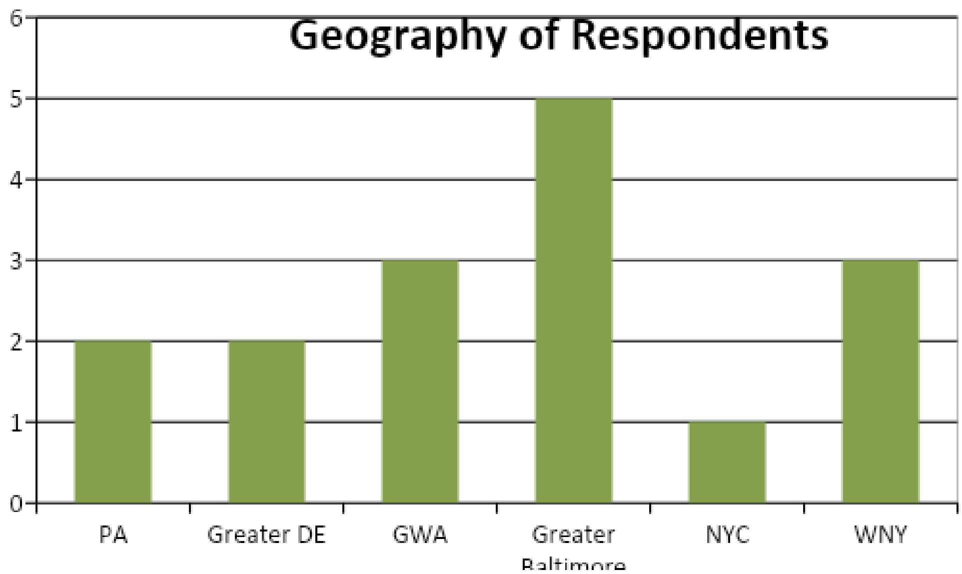


Figure 1

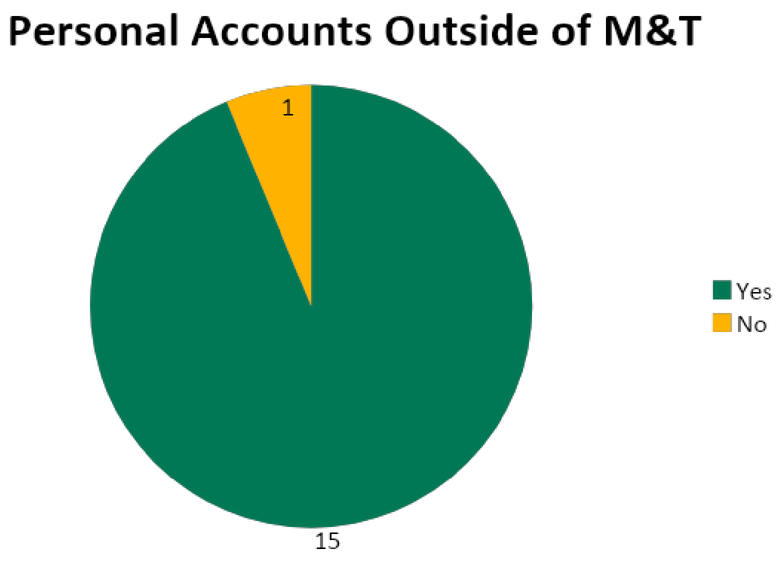


Figure 2

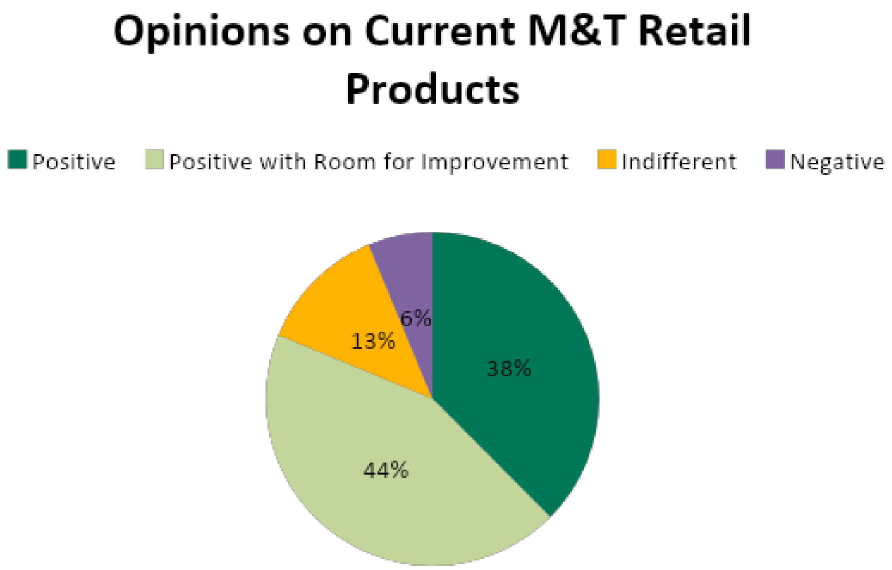


Figure 3

Checking Accounts:

As of December 2015, M&T offers six different Checking Accounts for retail customers. Each account is tailored to a customer's specific needs and benefits that they are looking to obtain. Each account also contains different requirements that a customer must meet on a monthly basis to keep the account active without any service charges.

Checking accounts are the most frequently utilized account for retail customers. M&T will continue to measure the tradeoff between keeping high balance requirements and how much a customer brings of their assets to M&T. For example, if the balance requirement is too high, it may deter some retail customers from opening an account at M&T, however, with LCR solidifying itself as a prominent issue we now know the value of those deposits.

MyChoice Premium Checking	MyChoice Plus Checking With or Without Interest	MyChoice Checking
Requirements: - $7500 Average Daily Balance - $25,000 Combined Balance within all accounts	Requirements: - $2000 in Direct Deposit per month - $2,500 Average Daily Balance	Requirements: - $200 in Direct Deposit per month OR - $500 Average Daily Balance OR - 10 M&T debit card purchases per month
$24.95 monthly maintenance fee	$14.95 monthly maintenance fee	$6.95 monthly maintenance fee

EzChoice Checking	Basic Banking	M&T Classic Checking (Age 50+)
Requirements: - Make at least ONE transaction per month	Requirements: - None	Requirements: - Direct Deposit OR - $500 Average Daily Balance OR - $1500 in Checking and Savings OR - 10 M&T debit card purchases per month
$9.95 monthly maintenance fee *$6.95 in Feb. 2016	$3.00 monthly maintenance fee	$4.95 monthly maintenance fee

Suggestions for improvement

M&T's checking products are strong. There are diverse options to appeal to many demographics. However, there is a significant demographic of consumers that our checking products overlook: college students and young professionals. The EzChoice checking account is the easiest to maintain and the most appealing product to someone who is new to personal banking, but it does not encourage the customer to have any ties to M&T other than their checking account. Since LCR is something we must consider when evaluating the value of our retail relationships from here on out, it makes sense to encourage customers to start out their personal banking relationship with us while they are young so that we can retain that relationship as their deposits grow. Our survey respondents enforced the need to appeal to this demographic through a linked checking and savings account, a better mobile platform, and other starter accounts.

Savings Account:

As of December 2015, M&T offers four different savings accounts for retail customers. Each account is tailored to a customer's specific needs and benefits that they are looking to gain from saving money. Each account also contains different requirements that a customer must meet on a monthly basis to keep the account active without any service charges. A Relationship Savings account can be utilized as a free addition to any checking account of MyChoice or above, meaning that there is no required minimum.

MyChoice Money Market	Relationship Savings	M&T Starter Savings	M&T e-money Market
- Minimum daily balance of $2500 - Have a MyChoice Premium Checking account	- Minimum daily balance of $500 OR - Have an M&T personal checking account other than Free checking or EZchoice checking	N/A	N/A
$15 monthly maintenance charge	$7.50 monthly maintenance charge	$0 monthly maintenance charge	$0 monthly maintenance charge

Suggestions for improvement

As aforementioned, the best way for M&T to increase their retail deposits is to appeal to the college student and young professional demographics (early to mid-20s). Our current savings product that does not contain a minimum balance requirement is the Relationship Savings. However, in order to avoid the minimum balance requirement, the customer must have a checking account other than the EzChoice Checking, which is the most appealing account to the early to mid-20s demographic. Six of our survey respondents suggested linking a savings account with the EzChoice checking with no minimum balance in order to encourage our customers to save at a beginner level as well as to create another tie between the bank and the customer.

Time Deposits:

As of December 2015, M&T offers five different types of Time Deposit accounts, which are often called CDs (Certificate of Deposit). CDs are typically opened by retail customers who would like to save their money in a secure location with a guaranteed fixed rate of interest to collect. These deposits can vary in length usually anywhere from 6 months to 10 years, and are not very liquid. Time deposits and certificates of deposits: while conservative, these assets are also producing very low returns due to demand from money market funds that have lost their repo supply. The highest LCR value is provided to term deposits with a remaining maturity of greater than 30 days, which have a 0% LCR runoff. This is what makes time deposits very valuable for the future of the banking industry.

Fixed Rate CDs	Add-on Time Deposit	Step Up CD
<u>Requirements:</u> - $1,000 minimum deposit - Term is 32 days to 10 years	<u>Requirements:</u> - $1,000 minimum deposit - Term is 6 months and 1 year	<u>Requirements:</u> - $1,000 minimum deposit - Term is 2 years
Fixed Rate and Compounded Daily	Fixed Rate with Simple Interest	Fixed Rate and Compounded Daily

Suggestions for improvement

The biggest way to improve our time deposit products is through higher interest rates. However, these rates are highly dependent on market interest rates, therefore it is difficult to make any concrete suggestions for improvement on something that is largely beyond M&T's control.

Loans, Credit Cards, Mortgages, and HELOC:

In addition to retail deposit accounts, M&T offers a variety of products that are designed to reduced obstacles for customers looking to make large purchases. Personal loans are offered to retail customers who are looking to make a larger purchase, but just do not have the funds readily available. M&T assists our customers by providing a monetary loan that the customer pays back over a specified period of time with interest included.

M&T offers three credit card options.

M&T Visa Credit Card	M&T Visa Credit Card with Rewards	M&T Visa Signature Card
Most basic card offered	1 point for every $1 spent	1.5% cash back for every $1 spent
10.24%, 13.24%, or 17.24% APR	11.24%, 14.24%, or 18.24% APR	14.24% or 18.24% APR

Mortgages are offered to customers who would like to purchase a house for themselves or their families. M&T is actively engaged in mortgages and even has developed a "First time Home Buyer Program" to help educate customers on the aspects of taking out a home mortgage. Home Equity Lines of Credit (HELOC) also are sold to retail customers who need a loan, but would like to back that loan by using the value gained on their house to serve as a collateral in the case of the loan defaulting.

From an LCR standpoint, these types of products are not very liquid. However, by offering these products M&T is able to develop a larger customer market than if they did not offer it. Many customers who have mortgages with us have built a strong relationship with the bank and consequently will usually bring their other retail deposits to our accounts. All in all, mortgages and loans are not our most liquid assets, but those are the items that can help build relationships for the long term.

Suggestions for improvement

Although these types of products are not very liquid and therefore are not a part of our core retail products that will benefit LCR, there is one product improvement to our credit card that was suggested by many of our survey respondents. M&T does not offer a cash secured credit card, which allows customers to put down a cash deposit on a card in exchange for a small credit line. This allows customers to build their credit and is often referred to as a starter credit card. While this product may not directly affect LCR, it would allow M&T to appeal to the early to mid-20s demographic that will be critical for the future success of the bank.

Mobile Banking:

Mobile technology is not a product that actually adds deposits to M&T's balance sheet; however, it is a huge selling point for customers who like to bank conveniently from their mobile devices. For the millennial generation, technology has been a part of their lives forever and it is necessary for M&T to invest in these types of technology in order to capture that demographic.

Currently M&T has a few different options when attempting to access online banking. Mobile text banking is a product that allows customers to "check your balance in less than ten seconds". The customer simply sends a 1 to 3-letter message to M&T's text banking phone number, and instantaneously will receive a text back with a response to their inquiry. Next, is mobile online banking, which allows customers to log on to mtb.com and view their account balances, make transfers, and pay bills. Also, there is the Mobile application for IPhone and Android phones that is a consolidated version of the mtb.com account overview where customers can access the same information as the full website. Another mobile feature are the bank alerts that can be set up to notify customers of recent activity on any of their accounts.

Suggestions for improvement

M&T's mobile platform is the source of many complaints from retail customers. Creating a more user friendly mobile platform would be a huge improvement in customer service for M&T. This improvement will also help M&T attract a younger customer base and build loyalty with those customers as their deposits increase. A product like PNC's Virtual Wallet, a linked checking, short term and long term savings account all visible and easily transferrable on their mobile application, is one way to improve M&T's mobile platform. Other suggestions from our survey respondents were mobile check deposit and peer to peer lending through M&T's mobile application.

Retail Product Breakdown

With LCR coming into effect on January 1, 2016 there is increased pressures for M&T to build up the quantity of high-quality liquid assets that the bank is holding at any point in time. A 30-day stress test is designed to pick up a number of different impacts on the liquidity profile of the organization. From the liability side, it will capture the speed with which wholesale markets can react to bad news by withdrawing access to unsecured funding.

Furthermore, the runoff of a proportion of retail deposits is assumed, and by dividing the retail deposits into stable and unstable ones, the ratio is recognizing that deposit protection schemes that are able to pay out quickly could slow the loss of retail deposits. A customer with a stable relationship with a bank may withdraw deposits more slowly, which helps to prevent bank runs.

As Basel III's intent to help ensure that banks are adequately capitalized in the event of financial stress retail deposits have grown in value. The net effect of the LCR standard is that retail deposits will be treated under certain run off assumptions. Under this regulation, each deposit is assigned a runoff percentage, which indicates over a 30-day stressed environment how much capital will be removed from the bank's balance sheet by their customer base. For retail deposits the proposed percentage is lower than most other categories and can be as low as 3%. This is an important aspect for properly maintaining M&T's balance sheet to remain compliant with the required LCR rating. The reason why retail deposits are considered more favorable under a 30-day stress test is because of the backstop in place by the FDIC. Due to the fact that retail accounts are insured up to $250,000 per legal entity it inclines customers to keep their money inside of the bank and to weather the financial storm that is occurring.

Deposit Comparison

For the retail side it is important to keep a large quantity of liquid assets on our balance sheets and none are better than retail deposits. These deposits are great counterparts to the LCR ratio standard and can help to provide protection against a 30-day stress test on the bank in the case of an economic downturn. With each category of deposits receiving a different runoff percentage with LCR, it becomes essential to look at how M&T's rating will change according to which assets are added to their balance sheet.

As touched upon earlier, retail deposits into checking or savings account provide great value to the overall LCR rating at 3% runoff because of the high probability that they will not be withdrawn in the scenario that the economy becomes stressed. Therefore, M&T has developed the mindset to keep retail deposits growing at the quickest rate possible to build up our buffer against the LCR ratio requirement of 100. Non-operating/excess balances are assigned a 40% runoff rate for corporations and government entities and 100% for financial institutions, making them the least valuable to banks. The highest LCR value is provided to term deposits with a remaining maturity of greater than 30 days, which have a 0% LCR runoff. With this concept, M&T has goals to continue to sell time deposits that have a maturity length of over 30 days. Despite interest rates yielding at an all-time low, we must continue to make time deposit sales to better safeguard our assets across the board.

Due to the 0% runoff standard applied to time deposits, we have recognized other banks developing new products to better position themselves under compliance. A 31-day CD has become a newly talked about product that offers a great combination of security for both the customer and the bank. Under LCR, a 31-day CD will serve as protection for the bank to beat the 30-day stress test and maintain a 0% runoff, while also increasing deposit numbers. For the customer, the CD is still FDIC insured and creates a way to earn interest that is compounded daily at a fixed rate regardless of what direction that market has turned in. M&T will likely look to invest in the creation of this type of product throughout the year 2016.

M&T Regional Analysis

With LCR becoming a federal regulation that M&T must be fully compliant with by January 1st, 2017, the issue has pressed research to find out what types of deposits M&T currently maintains and which ones will need to increase. After a comprehensive research attempt by the LCR team at M&T, it has been concluded that M&T will be able to reach the 90% LCR requirement for 2016 and the full 100% LCR requirement for 2017.

In order to better understand how M&T has met these standards it is important to assess how deposits have changed for M&T over the course of 2015. The graph below shows all the deposit numbers for two different regions within the M&T footprint, Greater Delaware and Western New York. There is evidence that retail deposits have risen in both regions despite the number of households decreasing. This assumes that less customers are using deposit services, but for the ones that are we are starting to recognize a large amount of funds being placed into the bank. This is good for LCR, especially when loan amounts have been slightly trending in the opposite direction. M&T hopes that in 2016 we do not to slide too far from earning a plentiful amount of loan deposits, but from an LCR standpoint it will not be too detrimental as long as consumer deposits continue to grow. Below is a chart that breaks down how these numbers were obtained.

Greater Delaware *(As of September 2015)*

Prior YTD	Current YTD
Total Consumer Households – 184,360 Contribution - $124,765,352	Total Consumer Households – 180,653 Contribution $133,331,940
Consumer Accts. – 112,821 *Trans. Vol.* – 216,503 Business Banking – 22,544 *Trans. Vol. – 96,806* Commercial – 3,853 *Trans. Vol. – 23,999* Other – 2,542 *Trans. Vol. – 14,553* Total Allocated Balance - $2,441,957,516	Consumer Accts. – 100,150 *Trans. Vol. – 184,904* Business Banking – 20,448 *Trans. Vol. – 84,409* Commercial – 3,532 *Trans. Vol. – 21,739* Other – 1,971 *Trans. Vol. – 12,290* Total Allocated Balance - $2,611,070,190

Figure 4

Deposit Balances YTD	Loan Balances YTD
Consumer DDA – 536,867,058 (+4.5%) Consumer Other – 3,001,441,390 (-0.3%)	Consumer Loans – 537,679,617 (+0.0%) Business Banking – 527,997,593 (-3.3%) Mortgages – 2,740,364,597 (-5.6%)

Revenues:

	Prior YTD	Current YTD
Deposits Net Income	$44,774,720	$59,437,811 (+32.7%)
Loans Net Income	$30,720,774	$29,566,022 (-2.3%)

Western New York *(As of September 2015)*

Prior YTD	Current YTD
Total Consumer Households – 326,971 Contribution - $131,908,555	Total Consumer Households – 319,278 Contribution $156,427,228
Consumer Accts. – 217,507 *Trans. Vol* – 403,698 Business Banking – 41,123 *Trans. Vol. – 182,526* Commercial – 10,239 *Trans. Vol. – 78,826* Other – 3,016 *Trans. Vol. – 21,265* Total Allocated Balance - $2,6,140,140,192	Consumer Accts. – 187,659 *Trans. Vol. – 335,903* Business Banking – 37,594 *Trans. Vol. – 162,710* Commercial – 9,490 *Trans. Vol. – 72,192* Other – 2,692 *Trans. Vol. – 20,665* Total Allocated Balance - $5,277,596,099

Deposit Balances YTD	Loan Balances YTD
Consumer DDA – 685,327,759 (+6.2%) Consumer Other – 5,046,294,251 (+0.7%)	Consumer Loans – 1,045,917,188 (-1.0%) Business Banking – 912,417,697 (-1.8%) Mortgages – 3,447,254,308 (-1.4%)

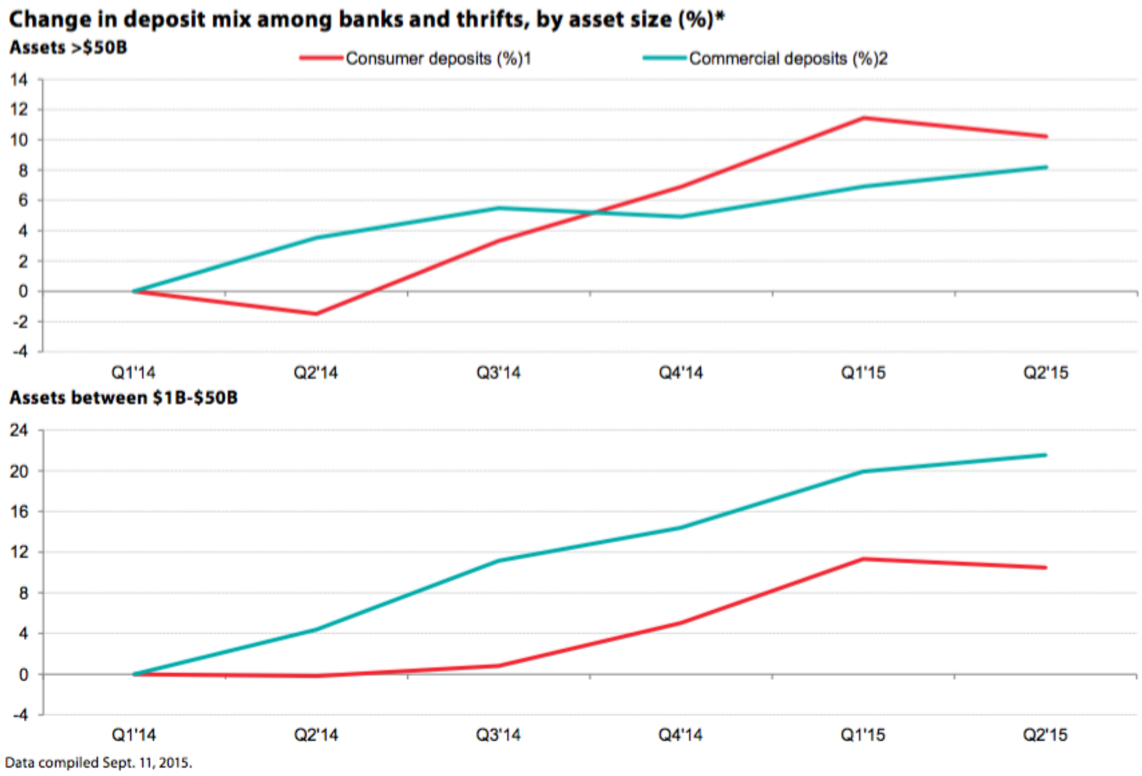
Revenues*:*

	Prior YTD	Current YTD
Deposits Net Income	$74,919,256	$103,139,296 (+37.6%)
Loans Net Income	$54,117,639	$53,821,836 (-0.5%)

Industry Analysis

After analysis across several of M&T market regions there seems to be an upward trend of retail deposits and a slight decrease in the number of loans that we are selling. However, while researching the trends of peer banks we notice the adoption of this trend across the board. Banks with more than $50 billion in assets have grown their consumer deposits by 10.2% since the first quarter of 2014. Banks with assets between $1 billion and $50 billion have grown those balances by nearly 10.5% during the same period.

As shown in the graph below, bank below $250B in assets under management began to see a decrease in the number of consumer deposits from 2014 to 2015. This trend is primarily connected to the record low interest rates that are being yielded for customers who have kept their deposits within the traditional retail bank. Now we are entering into the 2016 fiscal year with aspirations to begin earning more consumer deposits due to the recent increase of interest rates. On December 16th, 2015 the Fed sat down and agreed to raise the interest rate up 25 basis points from 0.25 to 0.50. This movement is not too substantial, but it really helps M&T and all other banks going forward into the new year to generate more opportunities to earn consumer deposits.



Other banks have also taken the initiative of tackling LCR before the full requirement is put into place, especially those banks with over $250B in assets who are already complying. "The balance of excess reserves at the largest banks was consequently lower at the end of the second quarter of 2015 year-over-year, after peaking at the end of the first quarter of 2015. Consequently, retail deposits account for a larger share of the mix of deposits at the largest banks than they did a year ago," Heisler wrote in mid-August.

- http://www.bankingexchange.com/news-feed/item/5761-lcr-shaking-up-bank-deposits

Some of the country's biggest banks have actively worked to reduce commercial deposits. JPMorgan Chase & Co. noted on its second-quarter earnings conference call that it has decreased non-operating deposits across its wholesale business by $100 billion this year. The company said the decrease was partially offset by growth in consumer deposits.

JPMorgan further noted that its high-quality liquid assets had fallen $82 billion in the quarter, primarily due to lower levels of cash, but said the company remained LCR-compliant since it had shrunk deposits that receive less favorable treatment under the provision.

JPMorgan CFO Marianne Lake said on the call:

"But we are expecting retail deposits to reprice higher and faster in this cycle than in previous rising rate cycles, given the competition for good, high-quality, LCR-compliant retail deposits; given the advancements in mobile banking; given the awareness in the general environment around low rates and the desire to participate in rising rates. So when we think about our sensitivity and our reprice, we model it in assumption that it's going to be higher, somewhat higher."

Hudson City

With the acquisition of Hudson City Bank in November, M&T has finally solidified the 3-year deal that they have been working diligently on. Due to increased federal regulation M&T needed to improve their processes for collecting information on customers' money-laundering risks and for managing consumer complaints. After these issues had been resolved we were finally able to move through with the purchase of Hudson City Bank. Hudson City Bank is the largest savings bank in New Jersey and one of the oldest banks in the United States, with $50 billion in assets. As a savings bank, Hudson City only sold products that were term deposits, loans, and savings accounts.

Under the LCR standard, Hudson City's acquisition adds a somewhat symmetrical split of assets of mortgage loans and term deposits to M&T's balance sheet. The mortgage loans will not positively contribute to our LCR ratio because they will subject our rating to long-term contracts that will not be considered highly liquid. However, the high number of CDs that Hudson City is bringing to the table will really prove to be beneficial. These term deposits won't be subject to the volatility in the market under the 30-day stress test. It will be interesting to see if a lot of Hudson City customers will also keep their CDs with M&T going forward and if a 31-day CD will be introduced to those customers if we decide to publish it.

M&T Sales Process to benefit LCR

M&T Bank over the years has created a unique culture that was instilled upon all of their employees. The primary message reads that M&T is a community bank that truly focuses on the value of building strong customer relationships amongst those who bank with us. M&T is actively engaged within the community whether it is for charity, town events, or even little league sports. Our ultimate goal is to positively affect the communities that we are present in, one customer at a time.

Speaking on behalf of all the Retail MDPs that are in the branches, we understand the most about how the M&T sales process is structured. Through various training sessions outside of the office it has been clear that we have a duty to serve the community in the best way possible as an employee of M&T. When customers come into our offices we strive to provide them with the best options for their financial futures and would never recommend a product that may not be beneficial to them. Under that philosophy, M&T employees are quick to gain the respect of customers and start to build a trusted relationship from the first interaction. If that customer runs into a difficult financial situation later on they now have a trusted branch representative that can help guide them through the financial trouble because of the strong rapport already established. This is the primary reason M&T has remained successful over its extended history and it has repeatedly influenced customers to remain loyal M&T customers for years to come.

From an LCR standpoint, this overall sales process can really benefit our effort to keep our LCR rating high enough to reach the requirement and build enough of a buffer zone in case something was to suddenly change in M&T's financial structure. We believe that it is more important than ever for M&T employees to focus on keeping strong relationships with our customer base. A customer who is loyal to the M&T brand will more likely be inclined to keep their money within our banks and possibly look to invest in LCR-friendly products such as Time Deposits. Continuing to build these key relationships will be a way that we can help maintain our LCR level without "pushing the product" on our customers. M&T has never been a bank to stray away for our principles and if we continue that mentality going forward our LCR rating will remain high because of the strong customer relationships we have obtained.

Operational Vs. Non Operational Deposits

Overview:

Under LCR rule not all commercial deposits are weighted equally. When reviewing cash in deposit accounts, the regulators determined that only the cash required to fund a company's upcoming payments would be likely to remain on deposit during a time of stress. Therefore, commercial deposits identified as operational require the bank to hold significantly less HQLA against the liability than non-operational deposits. This provides a challenge for banks going forward to accurately identify operational deposits, to develop a strategy to maintain a profitable deposit mix, and to grow commercial deposits.

	Non-Operational Deposit	Operational Deposit
HQLA Requirement for Non Insured Deposits	28%	17.5%
HQLA Requirement for FDIC Insured Deposits	14%	3.5%

Risks:

- **Regulatory Risk:** LCR regulation outlines 8 requirements that deposit accounts must meet in order to be classified as operational. The most difficult task is to prove a deposit account is empirically linked to the operational services of a business. With no clear classification methodology from regulators, banks face the risk of incorrectly identifying deposits as operational. Conversely, being too tentative to classify deposits as operational will negatively affect the bank's profitability by carrying unnecessary HQLA. Banks must also be wary of creating deposit accounts designed to create an economic incentive for the customer to maintain excess funds, as these accounts will be deemed non-operational.

Industry Analysis:

All full and modified LCR banks are adjusting their deposit strategy to maximize profitability while remaining LCR compliant. JP Morgan Chase has been outspoken about their strategy in 2015. In February 2015 the bank announced plans to exit $100B of unfavorable deposits from their commercial portfolio. JP Morgan Chase, along with other full LCR banks, has also announced plans to start charging fees on customer's non-operational deposits in order to make holding the deposits profitable. The fees will be determined depending on the bank's relationship with each client. Lastly, LCR banks are pushing customers with deposit viewed as temporary towards money-fund sweep accounts in order prevent excess funds from simply sitting on their balance sheet.

Recommendation

LCR regulation will shift how M&T approaches commercial deposits. While M&T is challenged with accurately identifying the types of commercial deposits and optimizing our deposit risk, there is opportunity for the bank to acquire “de-banked” businesses from larger banks. Being a modified LCR bank allows us to hold less HQLA against commercial deposits than full LCR banks. Therefore, we must seek opportunities to acquire relationships from full LCR banks that have less profitable liquidity and leverage ratios. M&T needs to pay particular attention to Global Systemically Important Banks (GSIBs) as these banks face even further capital return challenges and have been forced to be especially aggressive in exiting less profitable deposit accounts. Additionally, M&T needs to utilize Wilmington Trust tools to encourage customers to move non-operational deposits into securities and other products that do not fall subject to LCR regulation. It is important for M&T to keep open dialogue with regulators to ensure treasury’s method for identifying operational deposits is accurate.

International LCR Implementation

Overview

LCR implementation has already been in effect for both EU and non-EU European countries and several Asia-Pacific countries as of 1Q 2015, with reporting beginning in 1Q 2016. Several major European banks have published reports regarding regulation interpretations, compliance best practices and related challenges. The majority of these challenges are in regards to HQLA requirements, as European banks have historically heavily relied on HQLA to provide loans for their clients. Few products specifically targeting LCR have been introduced, including the perpetually resetting CD. Currently, European banks are offering similar products that exist in the US market. These products were designed to increase overall retail deposits and encourage non-operational deposits to be moved into off-balance sheet products. The most notable product introduced in Europe was from the French bank BNP Paribas, which is offering a LCR-specific open fund for increasing LCR numerator short-term for EU clients. Several European banks are giving low and negative rates to discourage unattractive deposits from staying on their balance sheet— a tactic now used in the US. The Asia-Pacific regions is also offering similar products to the perpetually-resetting CD, in addition to considering using rates to strategically limit customers' unattractive deposits.

Foreign Products and Solutions

Compared to products currently offered in the US, European and Asia-Pacific products are fairly similar in their purpose to limit non-operational deposits while increasing retail deposits and attracting customers who will maintain higher levels of operational deposits. In Australia and Europe, perpetually resetting CDs are available at both full-LCR and community banks, making it a viable option for average retail customers. Asia-Pacific banks are also looking into similar products that will be 31 days or longer, pushing deposits into off-balance sheet accounts, including money market funds (MMF).

BNP Paribas Lcr 1 (BNPLC1:FP)

Lcr 1 is an open-ended fund incorporated in France and offered to EU clients. Issuers and securities that are selected are high quality to exclusively ensure the short-term fund eligibility of LCR. Benchmark is Barclays Euro Aggregate Treasuries 1-5 year. Since its inception in June 2015, the fund has grown and has been a topic of discussion for francophone European analysts.

Foreign Industry Analysis

European banks have been largely taking regulations in stride as the EU and other European organizations have had more advanced regulations compared to the US prior to the financial crisis, though some commentators have said that the post-crisis “regulation avalanche” is limiting the ability of banks to grow. Many have noted that there are concerns regarding HQLA requirements that can leave banks unprepared for investment opportunities in a rebounding global market. However, when compared to Asia-Pacific banks, European banks are having a harder time with compliance. Notwithstanding country-specific adaptions for implementation for East and Southeast Asian banks, it’s fairly straightforward for the region to comply with Basel III legislation: “it would be almost unthinkable for banks to run loan-deposit ratios greater than 100%, for them to rely excessively on short-term deposits from wholesale or financial counterparties, or to fund illiquid assets with non-stable liabilities…When one has a robust funding structure in place already, and always had so, meeting the LCR requirement isn’t an issue at all” (Asian Banking and Finance).

Asia-Pacific analysts are optimistic towards LCR implementation across the region, but have emphasized differences in banking culture may influence compliance and reporting. Moreover, some analysts and commentators chide international regulators, reminding them of the fact that the ‘bulk’ of the global financial crisis was caused by European and American banks, implying that their compliance is to meet best practices, not to directly address structural risks. Yet, while smaller countries in the Asia-Pacific region have historically had stable loan-deposit ratios, due to limited HQLA and government bonds, they will have had to find workarounds in the regulation that would allow for compliance, but take into consideration the limitations of their local markets. To make matters worse, “[a] significant number of foreign banks in the Asia Pacific region and elsewhere are funded largely or partly intra-group, the treatment of which under the LCR (when local supervisors apply the LCR to the overseas subsidiaries of foreign banks) makes it difficult for the subsidiary to meet the 100% LCR coverage requirement”—something which international regulators will need to consider going into Basel IV (KPMG).

Lessons for American Industry

Based on the European experience, US regulators hopefully will be more forthcoming with any suggestions they have regarding implementation of the regulations prior to the mandatory implementation period. This would eliminate several critiques that have been posed not only by European banks, but also full-LCR US banks that have been at 90% implementation as of 1/1/15. European analysts have expressed concern that the US version of Basel III and LCR in particular is more stringent than it may need to be at present, considering the implementation of several other financial regulations like the Dodd-Frank Act. Additionally, European banks have shown that the challenge of attracting and keeping the right customers may prove to be more profitable than simply attracting larger consumer deposits due to HQLA requirements and differences in operational funding categorization. US banks have begun to notice this distinction in clientele, and are taking measures to limit non-operational deposits while maximizing the number of products for clients with large operational deposits.

The US industry should also look to Asia-Pacific banks for lessons and best practices regarding banking culture. Asia-Pacific banks—not to be confused with Asia-Pacific subsidiaries of European or US banks— have generally emphasized stability and longer-term interests rather than short-term investments with high risk. Going forward, this may prove to be integral in compliance and longer-term performance, where risk will likely be highly scrutinized and tracked by regulatory authorities.

Perpetually Resetting CDs

Overview:

The most popular new product developed out of the Basel III regulation is a perpetually resetting CD, mostly of 31-Days. The idea of the product is to take deposits for large non-operational clients and extend them beyond the 30 day window described in the LCR regulation. Under the regulation, if the deposit can be accessible within 30 days, then the deposit will count towards the LCR regulation. This product must A) perpetually reset the deposit to 31 day to keep the deposit outside of the calculation and B) be unbreakable so that the client cannot take their funds out, even if they pay a fee. When the client wants access to their funds, they must request that the maturity does not reset and then can access their funds in 31-Days, in which case the deposit will go in to the LCR calculation.

Risks:

- **Market Risk:** Since this product is new, we are not sure what the demand for these types of deposits are. The target audience for these products would be financial institutions (FI) that keep large sums of non-operating cash for extended periods. To minimize this risk, M&T can sell this specialized product to only select clients that are aware of the purpose of the new product. This can be worked into the treasury management teams that work with FI.

- **Regulatory Risk:** Since these products were specifically designed to circumvent the LCR regulation, there is a risk that the Federal Reserve will deem these products as noncompliant. The early feedback from the Fed has not been a firm “no” but has expressed concern that these products were “gaming the regulation”. Fortunately, as a modified LCR bank, M&T can afford to wait and see the Fed’s reaction to the full LCR banks next year. To minimize this risk, M&T can create longer maturity periods for their CDs extending beyond the very obvious 31-day limit.

Industry Analysis:

Banks known to have or are currently developing a Perpetually Resetting CD:

- JPMorgan Chase
- Capital One
- Bank of America
- Citigroup

The 31-Day Resetting CD was first introduced in Europe, the first region to adopt the Basel III regulations. Notably, Citigroup introduced the product into the U.S. market. Almost all products have several components in common.

- There cannot be any staggered deposits or any partial withdrawals.
- Interest rates are also determined upon request and are variable to adjust at any time.
- There is also no maximum investment.

All products are aimed at large financial institutions and other large deposit holders. With these specific clients, minimum deposits are listed very high, leaving this product only for an exclusive list of clients. This is most likely based on probability metrics and the operating costs associated with the introduction of a new product. This is also due to the audience of large financial institutions who are aware of LCR and understand the purpose of the new product.

Recommendation

A resetting CD is a common product being developed by the industry to help remove large non-operational deposits from the LCR calculation. It is facing market and regulatory scrutiny as the full LCR banks are starting to roll out these products ahead of the first reporting date. M&T bank should keep a close eye on the hurdles of bringing this type of product to market and remain flexible to adjust the product as needed.

Industry M&A Impact

Creating Industry Tiers

LCR is expected to change the structure of the banking industry. Now with significant and expensive hurdles to climb, banks are going to become more cognizant about size and growth. With LCR banks larger than $50 Billion now face a daunting task of LCR compliance as well as reporting. Since LCR shrinks margin and puts downward pressure on NII, naturally banks under the $50 Billion threshold maybe better off staying below regulatory scrutiny. Larger banks just below $250 Billion may also hesitate for growth due to the additional hurdle and scrutiny of reporting LCR daily as well as higher run-off rates in the LCR calculation. This leads us to believe that the impact of LCR will create three distinct tiers of bank sizes around the $50 and $250 Billion thresholds.

Tier 1	Larger than $250 Billion	Full LCR
Tier 2	Between $50 - $250 Billion	Modified LCR
Tier 3	Smaller than $50 Billion	No LCR

Costs of Infrastructure

If smaller banks desired to jump into the next tier, the most likely scenario would be to merge with an already large bank who has already invested in the reporting infrastructure to report LCR. 2015 marked the highest M&A activity since the dot.com era with deals worth $2.3 Trillion, up 46% from 2014. This M&A environment along with the new regulatory hurdles indicate that banking industry M&A will increase the next few years until distinct tiers will emerge. This can already be seen with the acquisition of First Niagara by Keycorp. As a modified LCR bank, Keycorp already had the infrastructure in place while, First Niagara had little room to grow before reaching the first threshold.

Acquiring Deposits

Another motivating factor is the importance to retail deposits on the bank’s balance sheet. For large diverse banks, the aversion or even loss of large commercial deposits will hurt their ability to lend and ultimately compress NII. All banks will focus and compete even more fiercely in the retail space than ever before. While all banks will increase focus on growing their retail deposits organically, we also expect larger banks to acquire smaller retail focused banks for their deposits. This may never be the primary motivation for M&A activity in the industry but would be an added factor in all M&A activity in the future.

Conclusion

The full effects of LCR have yet to hit the industry. Once the larger banks have made the investment into the reporting infrastructure to deal with LCR, we expect larger banks to increase M&A activity. This is due to a combination of increased sellers, small banks looking to avoid the infrastructure hurdle, and an increase of buyers, large banks seeking more retail deposits. Eventually we see the industry separating into three distinct tiers with M&A as the main driver for mobility.